

## § 73.53 [Corrected]

## R-5313D Long Shoal Point, NC [Corrected]

After the word "Boundaries," (page 11901, column 1), remove the words "Beginning at lat. 35°20'52"N., long. 76°43'09"W.;" and substitute the words "Beginning at lat. 35°20'52"N., long. 75°43'09"W."

Issued in Washington, DC, on April 20, 1990.

Harold W. Becker,

Manager, Airspace, Rules and Aeronautical Information Division.

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## COMMODITY FUTURES TRADING COMMISSION

### 17 CFR Part 1

#### Self-Regulatory Organization Automated Systems

**AGENCY:** Commodity Futures Trading Commission.

**ACTION:** Interpretative rule.

**SUMMARY:** The Commodity Futures Trading Commission is issuing this interpretation to make clear that the record retention requirements in its regulations apply to any records created by or for a self-regulatory organization to document the development, implementation, or maintenance of any automated systems supporting or incident to the performance of its self-regulatory responsibilities and functions.

**FOR FURTHER INFORMATION CONTACT:** Linda Kurjan, Special Counsel, Division of Trading and Markets, Commodity Futures Trading Commission, 2033 K Street NW., Washington, DC 20581, telephone: (202) 254-8955.

**SUPPLEMENTARY INFORMATION:** During recent years self-regulatory organizations ("SRO") have developed automated systems to perform, or enhance their ability to perform, their functions and responsibilities.<sup>1</sup> Such initiatives include electronic trading systems,<sup>2</sup> electronic order routing

systems,<sup>3</sup> hand-held trade entry terminals,<sup>4</sup> trade-checking and clearing systems, and automated surveillance programs. While many of these initiatives are still in the developmental stages, others are established systems to which enhancements are ongoing.

The development, implementation, and maintenance of an automated system typically are accompanied by extensive documentation. This documentation, which includes but is not limited to traditional systems development documentation, creates a historical record of those processes.<sup>5</sup> It records the steps taken to identify vulnerabilities in the system, to establish safeguards that address such vulnerabilities, and otherwise to ensure the system's technical accuracy, reliability, and ability to operate as intended. The information contained in such documentation may relate to such aspects as the physical environment of the system, the system's capacity, the operating system software, data integrity, access controls, user guidance, systems testing, internal controls, and contingency plans, among other things.

From an SRO's perspective, these materials, whether in computer media or hardcopy form, create a historical record of the decisions that were made regarding the requirements and design of the system and provide a basis for operational decisions, assessments, and enhancements. Separately, the availability of documentation to the Commission improves the capability of the agency to ascertain the SRO's compliance with requirements of the Commodity Exchange Act ("Act") and the regulations and to provide proper oversight of the system.<sup>6</sup>

<sup>2</sup> E.g., CBOT Electronic Order System ("EOS"); CME Trade Order Processing System ("TOPS").

<sup>4</sup> E.g., Automated Data Input Terminal ("AUDIT") to be developed jointly by CBOT and CME; the Commodity Exchange, Inc. project to develop hand-held terminals.

<sup>5</sup> Traditional systems development documentation would include items such as requirements analyses, systems design documents, program specifications, system test plans, training materials, user manuals, and operations manuals.

<sup>6</sup> The Commission has become increasingly active in monitoring technical aspects of contract market automated systems. For example, Commission staff have met separately on several occasions with CME staff and with CBOT staff to view demonstrations of Globex and Aurora and to discuss such matters as security features, capacity planning, performance characteristics, and backup and recovery procedures. In addition, Commission staff have examined plans and procedures for testing the Globex and ACC systems and have visited the site of the central computer for each of them to investigate the physical and logical security measures undertaken to protect the system. Additional oversight activities currently are

Access to documentation assists the Commission in identifying vulnerabilities that could adversely affect the SRO's ability to perform its responsibilities and in assessing a system's technical accuracy, reliability, and ability to operate as intended. For example, evaluation of documentation can indicate whether an SRO provides adequate safeguards to protect the computer system or process against such dangers as unauthorized access, internal failures, human errors, attacks and natural catastrophes that might cause improper disclosure, modification, destruction or denial of service. The documentation also could permit the Commission to use or run programs directly on SRO systems to test the quality of outputs of the system or other features.

Accordingly, the Commission is issuing this interpretation to make clear that, under existing requirements of the Act and Commission regulations, including Regulation 1.51 and sections 17p and q of the Act, documentation, as described above, must be retained for certain automated systems. Specifically, for any automated system that supports or is incident to an SRO's activities or responsibilities as a self-regulatory organization, such documentation must be retained by the SRO for five years, pursuant to Regulation 1.31.<sup>7</sup> By contrast, documentation relating to systems supporting an SRO's administrative functions as a business organization or employer, e.g., an automated payroll system, would not constitute "records" under that regulation.

Specifically, Commission Regulation 1.51(b) requires contract markets to keep full, complete and systematic records

underway with regard to each of these contract market systems.

The Commission has been an active participant in efforts to analyze issues regarding the use of new technologies and systems. For example, Commission staff have met with staff from both the National Institute of Standards and Technology and the Office of Management and Budget on several occasions to discuss security issues with respect to automated trading systems. In addition, Commission staff participated in a conference of regulators, developers and users of automated, screen-based trading systems. Furthermore, the Commission is chairing a working group within an international organization of financial-related regulators that is charged with studying, among other things, issues surrounding screen-based futures trading.

<sup>7</sup> This interpretation in no way limits or affects existing requirements for the creation and retention of specific records by SRO's such as those set forth in Commission Regulation 1.35 regarding trading records, among other provisions.

<sup>1</sup> For purposes of this interpretation, the term "self-regulatory organization" is used as defined in Commission Regulation 1.3(ee) and also includes a "clearing organization" as defined in Commission Regulation 1.3(d).

<sup>2</sup> E.g., Chicago Mercantile Exchange ("CME") Globex System; Chicago Board of Trade ("CBOT") Aurora System; and Amex Commodities Corporation ("ACC") Amex Access System.



that will clearly set forth all action taken as part of programs to ensure enforcement of contract market rules under section 5a(8) of the Act and Regulation 1.53 and to secure compliance with sections 5 and 5a of the Act, among others. Similarly, each registered futures association is required to develop comprehensive programs under sections 17p and q of the Act to implement and enforce compliance of rules approved by the Commission. Records must be retained for a period of five years and be available for Commission inspection in accordance with Regulation 1.31.

Furthermore, this responsibility rests with each SRO regardless of whether the documentation is in its physical possession or in that of a third party, such as an independent contractor or a vendor. The SRO must ensure access by Commission staff to the documentation if it is to demonstrate compliance with its self-regulatory obligations. The Commission will continue to review such documentation in monitoring the development, implementation and maintenance of particular SRO automated systems and in reviewing related compliance programs.

This interpretation is intended to clarify the requirement that documentation, as described above, relating to automated systems development, implementation, or maintenance that is created by or for the SRO must be retained and available for Commission inspection. The Commission intends to address the issue of what constitutes adequate documentation (that is, what types of documentation should be generated) in the course of subsequent oversight and regulatory activities. In that connection, and regarding regulation of SRO automated systems generally, the Commission is creating a task force to draw upon the experience and technical expertise of other Federal agencies. The Commission also plans to initiate further rulemaking and interpretive actions to articulate with greater specificity its regulatory interest in overseeing automated systems and the obligations of the self-regulatory organizations and other regulated market participants with respect to the creation, maintenance, operation and supervision of such systems.

Issued in Washington, DC, on the 24th day of April 1990.

Jean A. Webb,

Secretary of the Commission.

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 200 and 230

[Release No. 33-6862; 34-27928; IC-17452; File No. S7-23-88 Int, Series-121]

RIN 3235-AC65

### Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145

AGENCY: Securities and Exchange Commission.

ACTION: Final rule, rule amendments and solicitation of comments.

**SUMMARY:** The Commission is adopting Rule 144A, which provides a safe harbor exemption from the registration requirements of the Securities Act of 1933 for resales of restricted securities to "qualified institutional buyers" as defined in the Rule. The Commission additionally is soliciting further public comment on the definition of qualified institutional buyer as it applies to banks and savings and loan institutions under the Rule as adopted today.

The Commission also is adopting amendments to Rules 144 and 145 under the Securities Act, which redefine the required holding period for restricted securities, whether acquired pursuant to Rule 144A or otherwise.

**DATES:** Effective Date: April 30, 1990.

*Comment Date:* Comment letters on the definition of qualified institutional buyer, as it applies to banks and savings and loan institutions should be received on or before June 14, 1990.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Comments should refer to File No. S7-23-88. All comments received will be available for public inspection and copying in the Commission's Public Reference Room at the same address.

#### FOR FURTHER INFORMATION CONTACT:

Brent H. Taylor (202) 272-3246, or Michael Hyatte at (202) 272-2573, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549.

#### I. Executive Summary

On October 25, 1988, the Commission proposed Rule 144A (the "Rule") to provide a non-exclusive safe harbor exemption from the registration requirements of the Securities Act of

1933 (the "Securities Act")<sup>1</sup> for specified resales of restricted securities to institutional investors.<sup>2</sup> As originally proposed, the Rule would have provided a safe harbor for three tiers of transactions. The first tier would have exempted only resales of restricted securities to "qualified institutional buyers," defined in the initial proposal as those with assets in excess of \$100 million, while the other two tiers would have provided an exemption for resales to a broader group of institutional investors. A number of commenters urged the Commission to proceed cautiously by adopting the Rule in stages. Most of the commenters suggesting a staged phase-in of the Rule favored proceeding initially with a rule that was available only to large institutional buyers. Several commenters suggested that a definition of "qualified institutional buyer" linked to securities investments would provide a better test of an institution's investment sophistication than the proposed total assets test.

On July 11, 1989, the Commission repropose a revised Rule 144A that would have established a single class of exempt transactions based on the "qualified institutional buyer" tier of the original proposal.<sup>3</sup> Specifically, the revised proposal would have defined "qualified institutional buyer" to be an institution, acting for its own account, that had assets invested in securities purchased for a total of more than \$100 million. The Commission noted that a definition focused on assets invested in securities should target, with more precision than the asset test originally proposed, sophisticated institutions with experience in investing in securities.

The Commission today is adopting Rule 144A. New Rule 144A provides a non-exclusive safe harbor exemption from the registration requirements of the Securities Act for resales to eligible institutions of any restricted securities that, when issued, were not of the same class as securities listed on a U.S. securities exchange or quoted in the National Association of Securities Dealers Automated Quotation system ("NASDAQ"). With the exception of

<sup>1</sup> 15 U.S.C. 77a et seq.

<sup>2</sup> Securities Act Release No. 6806 (October 25, 1988) [53 FR 44016]. Eighty-nine comment letters were received. These letters and a summary of such letters are available for public inspection and copying at the Commission's Public Reference Room in Washington, DC (File No. S7-23-88).

<sup>3</sup> Securities Act Release No. 6839 (July 11, 1989) [54 FR 30076]. Fifty-four comment letters were received. These letters and a summary of such letters are available for public inspection and copying at the Commission's Public Reference Room in Washington, DC (File No. S7-23-88).



registered broker-dealers, a qualified institutional buyer must in the aggregate own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with that qualified institutional buyer.

The Rule as adopted provides for an eligibility threshold of \$10 million in securities for broker-dealers that are registered under the Securities Exchange Act of 1934 (the "Exchange Act"),<sup>4</sup> irrespective of whether they are buying for purposes of intermediation or investment. In addition, to facilitate intermediation in this market, the Rule provides that a registered broker-dealer may purchase as riskless principal, as defined in the Rule, for an institution that is itself eligible to purchase under the Rule, or act as agent on a non-discretionary basis in a sale to such an institution.

In addition to meeting the \$100 million in securities requirement, banks and savings and loan associations must have a net worth of at least \$25 million to be qualified institutional buyers. Because of the unique status of such financial institutions as federally-insured depository institutions, the Commission is of the opinion that such an eligibility test is warranted. To avoid placing U.S. banks at a competitive disadvantage, the net worth test applies to both foreign and domestic banks. The Commission is soliciting further comment on the appropriateness of the net worth test for banks and savings and loan institutions, as well as on the appropriateness of the \$25 million level.

Registered broker-dealer affiliates of banks and savings and loan associations, which are subject to direct Commission oversight, would, however, be able to purchase under the Rule on the same terms as other registered broker-dealers. Such registered broker-dealer affiliates would not be required to meet the net worth test.

Where the issuer of the securities to be resold is neither a reporting company under the Exchange Act, nor exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act,<sup>5</sup> nor a foreign government eligible to use Schedule B under the Securities Act,<sup>6</sup> availability of the Rule is conditioned on the holder of the security, and a prospective purchaser from the holder, having the right to obtain from the issuer specified limited information about the issuer, and on the purchaser having received such information from the issuer, the seller, or a person acting on either of their behalf, upon request.

Although the Rule imposes no resale restrictions, a seller or any person acting on its behalf must take reasonable steps to ensure that the buyer is aware that the seller may rely on the exemption from the Securities Act's registration requirements afforded by Rule 144A.

The Commission also is adopting amendments to Rules 144 and 145 under the Securities Act.<sup>7</sup> Rule 144 permits the public resale of restricted securities when certain conditions, including a minimum holding period, are met. Under the amendments, the time that must elapse before public resale of restricted securities (whether acquired in reliance on Rule 144A or otherwise) is being redefined to commence when the securities are sold by the issuer or its affiliate. In contrast to the reproposal, the amendments apply to the securities of foreign as well as domestic issuers. Because Rule 145 holding periods are determined by reference to Rule 144, Rule 145 is being amended to reflect the changes to Rule 144.

## II. New Rule 144A

As discussed above, the Rule originally was proposed to apply to a broad range of institutions and securities. In response to numerous comments received on the possible effects of the Rule, the scope of the repropose Rule was narrowed to a modified version of the "qualified institutional buyer" first tier of the original proposal. Many of those commenters favoring an initially limited form of the Rule nonetheless stated that the Commission should either "phase-in" the various tiers of the Rule as originally proposed, or that it should closely monitor the impact of the Rule, with a view to expanding the Rule's scope as appropriate.

The Commission views Rule 144A as adopted today as the first step toward achieving a more liquid and efficient institutional resale market for unregistered securities. The Commission intends to monitor the evolution of this market and to revisit the Rule with a view to making any appropriate changes. Among the issues that the Commission would expect to consider would be the nature and number of regular participants in the market, the types of securities traded, the liquidity of the market, the extent of foreign issuer participation in the private market, the effect of the Rule 144A market on the public market, and any perceived abuses of the safe harbor.

## A. General

Rule 144A sets forth a non-exclusive safe harbor from the registration requirements of section 5 of the Securities Act<sup>8</sup> for the resale of restricted securities to specified institutions by persons other than the issuer of such securities. The transactions covered by the safe harbor are private transactions that, on the basis of a few objective standards, can be defined as outside the purview of section 5, without the necessity of undertaking the more usual analysis under sections 4(1)<sup>9</sup> and 4(3)<sup>10</sup> of the Securities Act. Each transaction will be assessed under the Rule individually. The exemption for an offer and sale complying with the Rule will be unaffected by transactions by other sellers.<sup>11</sup> The Commission wishes to emphasize that Rule 144A is not intended to preclude reliance on traditional facts-and-circumstances analysis to prove the availability of an exemption outside the safe harbor it provides.

By providing that transactions meeting its terms are not "distributions," the Rule essentially confirms that such transactions are not subject to the registration provisions of the Securities Act. In the case of persons other than issuers or dealers, the Rule does this by providing that any such person who offers and sells securities in accordance with the Rule will be deemed not to be engaged in a distribution and therefore not to be an underwriter within the meanings of sections 2(11)<sup>12</sup> and 4(1) of the Securities Act. Such persons therefore may rely on the exemption from registration provided by section 4(1) for transactions by persons other than issuers, underwriters or dealers. Dealers have the benefit of an exemption from registration under section 4(3) of the Securities Act, except when they are participants in a distribution or within a specified period after the securities have been offered to the public. The Rule provides that, if the conditions of the Rule are met, a dealer will be deemed not to be a participant in a distribution of securities within the meaning of section 4(3)(C) of the Act.<sup>13</sup>

<sup>8</sup> 15 U.S.C. 77e.

<sup>9</sup> 15 U.S.C. 77d(1).

<sup>10</sup> 15 U.S.C. 77d(3).

<sup>11</sup> See Rule 144A(e). This paragraph of the Rule was in the initial proposed Rule but was deleted from the reproposal. Commenters requested that it be reinstated, with a reference not only to the Rule's effect on the availability of any other exemption but on the availability of any safe harbor as well. The paragraph has been reinserted, modified in response to comments.

<sup>12</sup> 15 U.S.C. 77b(11).

<sup>13</sup> 15 U.S.C. 77d(3)(C).

<sup>4</sup> 15 U.S.C. 78a et seq.

<sup>5</sup> 17 CFR 240.12g3-2(b).

<sup>6</sup> 15 U.S.C. 77aa.

<sup>7</sup> 17 CFR 230.144 and 145.



and not to be an underwriter of such securities within the meaning of section 2(11) of the Act,<sup>14</sup> and the securities will be deemed not to have been offered to the public within the meaning of section 4(3)(A) of the Act.<sup>15</sup>

Nothing in the Rule removes the need to comply with any applicable state law relating to the offer and sale of securities. Similarly, the Rule does not affect the securities registration requirements of section 12 of the Exchange Act<sup>16</sup> or the broker-dealer registration requirements of section 15(a) of the Exchange Act<sup>17</sup> for a broker or dealer who effects private resales.<sup>18</sup>

In the case of securities originally offered and sold under Regulation D of the Securities Act,<sup>19</sup> a person that purchases securities from an issuer and immediately offers and sells such securities in accordance with the Rule<sup>20</sup> is not an "underwriter" within the meaning of Rule 502(d) of Regulation D. Issuers making a Regulation D offering, who generally must exercise reasonable care to assure that purchasers are not underwriters, therefore would not be required to preclude resales under Rule 144A. Similarly, the fact that purchasers of securities from the issuer may purchase such securities with a view to reselling such securities pursuant to the Rule will not affect the availability to such issuer of an exemption under section 4(2) of the Securities Act from

the registration requirements of the Securities Act.

#### B. Eligible Securities

Rule 144A would not extend to the offer or sale of securities that, when issued, were of the same class as securities listed on a national securities exchange registered under section 6 of the Exchange Act<sup>21</sup> or quoted in an automated inter-dealer quotation system.<sup>22</sup>

Accordingly, privately-placed securities that, at the time of their issuance, were fungible with securities trading on a U.S. exchange or quoted in NASDAQ would not be eligible for resale under the Rule.

Where American Depositary Shares ("ADSs") are listed on a U.S. exchange or quoted in NASDAQ, the deposited securities underlying the ADSs also would be considered publicly traded, and thus securities of the same class as the deposited securities could not be sold in reliance on the Rule.

For purposes of the Rule, common equity securities will be deemed to be of the same class if they are of substantially similar character and the holders thereof enjoy substantially similar rights and privileges.<sup>23</sup> Preferred equity securities will be deemed to be of the same class if their terms relating to dividend rate, cumulation, participation, liquidation preference, voting rights, convertibility, call, redemption and other similar material matters are substantially identical. Debt securities will be deemed to be of the same class if their terms relating to interest rate, maturity, subordination, security, convertibility, call, redemption and similar material matters are substantially identical. Preferred and debt securities commonly viewed as different series will generally be viewed as different, non-fungible classes of securities for Rule 144A purposes.<sup>24</sup>

In order to prevent evasion of the Rule's non-fungibility condition through use of convertible securities, the Rule as repropounded would have been unavailable for resales of convertible

securities unless such securities were non-convertible for three years. This provision has been revised to avoid undue interference with common financing activities. Under the Rule, a convertible security is to be treated as both the convertible and the underlying security unless, at issuance, it is subject to an effective conversion premium of at least 10 percent.<sup>25</sup>

Similarly, warrants, either trading as part of a unit with another security or separately, will be treated as securities of the same class as the underlying security unless the warrant has a life of at least three years and an effective exercise premium of at least 10 percent.<sup>26</sup> The Rule has been revised to provide that the Commission may designate additional securities and classes of securities that will not be deemed of the same class as an underlying security.<sup>27</sup> This change and

<sup>25</sup> The effective conversion premium of a convertible security, expressed in monetary terms, is its price at issuance less its conversion value (the aggregate market value of the securities that would be received upon conversion). For purposes of the Rule, the effective conversion premium is to be expressed as a percentage of the conversion value. The conversion value is to be determined by reference to the market price of the underlying security on the day the convertible security was priced. The market price of the underlying security may be determined by reference to any bona fide sale price in a transaction occurring on a national securities exchange or automated interdealer quotation system on the day of pricing of the convertible security.

<sup>26</sup> The effective exercise premium of a warrant is its price at issuance plus its aggregate exercise price less its exercise value (the aggregate market value of the securities that would be received upon exercise). For purposes of the Rule, the effective exercise premium is to be expressed as a percentage of the exercise value. The exercise value is to be determined by reference to the market price of the underlying security on the day the warrant is priced.

For example, if the price of a warrant at issuance is \$10, and it is exercisable into 10 shares of common at \$25 per share (i.e., the aggregate exercise price is \$250, the product of \$25 multiplied by 10), and the market price of the common is \$23 on the day the warrant is priced (i.e., the exercise value is \$230, the product of \$23 multiplied by 10), then the effective exercise premium would be 13.04% (\$20 [obtained by subtracting the exercise value of \$230 from \$250, the sum of the warrant's price at issuance (\$10) and its aggregate exercise price (\$250)] as a percentage of \$230).

In private placements, subunderwritten offerings and similar transactions, there may be different prices at issuance and different days of pricing of convertible securities or warrants. In such cases, the market price of the underlying security shall be determined as of the date of pricing of the convertible security or warrant first sold to a person not affiliated with the issuer, and the issue price of the convertible security or warrant shall be the lowest price at which such security is issued.

<sup>27</sup> Authority to designate such additional securities and classes of securities is delegated to the Director of the Division of Corporation Finance.

<sup>14</sup> 15 U.S.C. 77b(11).

<sup>15</sup> 15 U.S.C. 77d(3)(A).

<sup>16</sup> Broker-dealers are required to register with the Commission pursuant to section 15(a) of the Exchange Act. See 15 U.S.C. 78o(a).

<sup>17</sup> 15 U.S.C. 78o(a).

<sup>18</sup> Likewise, the Rule will have no effect on the application of Rule 10b-6 under the Exchange Act to an offer and sale of securities pursuant to Rule 144A "that is distinguished from ordinary trading transactions by the magnitude of the offerings and the presence of special selling efforts and selling methods." Rule 10b-6(c)(5) [17 CFR 240.10b-6(c)(5)]. It is unlikely, however, that ordinary resale transactions, in the form of block trades or otherwise, effected in compliance with the Rule would fall within the definition of "distribution" in Rule 10b-6.

Commenters inquired about the application to transactions under the Rule of section 11(d)(1) of the Exchange Act, limiting the extension of credit by broker-dealers in distributions of new issues. The comments did not make clear the likely impact of section 11(d)(1) in this market, particularly given the constraints of the margin provisions of Regulation T under the Exchange Act [12 CFR part 220 *et seq.*] and the limited use of credit by institutional buyers in most transactions. The Commission staff, however, is prepared to consider providing interpretive relief under section 11(d)(1) in appropriate circumstances for resales under this Rule.

<sup>19</sup> 17 CFR 230.501-506.

<sup>20</sup> The Rule is not available for a transaction that, although in technical compliance therewith, is part of a plan or scheme to evade the registration provisions of the Act. See Preliminary Note 3 to Rule 144A.

<sup>21</sup> 15 U.S.C. 78f.

<sup>22</sup> Consistent with the use of the term in Rule 12g3-2(d), an "automated inter-dealer quotation system" would include NASDAQ but would exclude bid and ask quotations in the current "pink sheets" of the National Quotation Bureau, Inc.

<sup>23</sup> This test is the same as that in section 12(g)(5) of the Exchange Act (15 U.S.C. 78i(g)(5)) and will be interpreted by the Commission in the same manner.

<sup>24</sup> It should be noted that with regard to non-investment grade non-convertible debt, use of the term "class" in the context of Exchange Act Rule 10b-6 may be interpreted differently than in the context of Rule 144A. See 17 CFR 240.10b-6 and Securities Exchange Act Release No. 19565 (Mar. 4, 1983) [48 FR 10628].



the revised criteria should assure that the Rule will not unduly interfere with common financing practices and still protect against use of convertible securities and warrants designed to evade the Rule's limitations.

As noted in Preliminary Note 3 to the Rule, transactions technically in compliance with the Rule that nevertheless are intended to evade the registration provisions of the Securities Act are not covered by the Rule. Thus, where an issuer resorted to use of convertible securities or warrants for the purpose of evading the restriction on fungibility, the Rule would not be available.<sup>28</sup>

### C. Eligible Purchasers

#### 1. Types of Institutions Covered

As discussed above, except for registered broker-dealers, to be a "qualified institutional buyer" an institution must in the aggregate own and invest on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the institution.

a. *Banks and Savings and Loan Associations.* Banks, as defined in section 3(a)(2) of the Securities Act,<sup>29</sup> and savings and loan associations as referenced in section 3(a)(5)(A) of the Act,<sup>30</sup> must, in addition to owning and investing on a discretionary basis at least \$100 million in securities, have an audited net worth<sup>31</sup> of at least \$25 million, as demonstrated in their latest published annual financial statements, as of a date not more than 16 months preceding the date of sale under the Rule in the case of U.S. banks and saving and loans, and not more than 18 months preceding such date of sale for foreign banks and savings and loans or equivalent institutions.<sup>32</sup> As federally-

insured depository institutions, domestic banks and savings and loans are able to purchase securities with funds representing deposits of their customers. These deposits are backed by federal insurance funds administered by the Federal Deposit Insurance Corporation ("FDIC").<sup>33</sup> In light of this government support, these financial institutions are able to purchase securities without placing themselves at risk to the same extent as other types of institutions. In this respect, banks and savings and loans effectively are able to purchase securities using public funds. Therefore, the amount of securities owned by a bank or savings and loan institution may not, on its own, be a sufficient measure of such institution's size and investment sophistication, and Rule 144A is intended to cover only resales to institutions that are sophisticated securities investors. A combined securities ownership and net worth test would appear to be a better measure of sophistication for banks and savings and loan institutions.

Foreign banks<sup>34</sup> and their U.S. branches are treated in the same way as domestic banks under the Rule.<sup>35</sup> The Commission is of the opinion that, for competitive purposes, it would not be appropriate to treat foreign and domestic banks differently under the Rule.<sup>36</sup>

An affiliate of a bank or savings and loan institution is not subject to the net worth test unless the affiliate is itself a bank or savings and loan institution. It should be noted that the eligibility of registered broker-dealer affiliates of banks and savings and loan associations to purchase securities under the Rule will be determined on the same basis as would apply in the case of other registered broker-dealers.

<sup>28</sup> Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Public Law No. 101-73, commercial bank deposits are insured by the Bank Insurance Fund ("BIF"). Savings and loan deposits are insured by the Savings Association Insurance Fund ("SAIF"). Both BIF and SAIF are administered by the FDIC.

<sup>29</sup> For purposes of the Rule, the term "foreign bank" means any entity defined as such by Rule 6c-9(b) (2) and (3) (17 CFR 270.6c-9(b) (2) and (3)) under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.).

<sup>30</sup> Although not expressly included in the definition of bank appearing in section 3(a)(2) of the Securities Act, the Commission has interpreted that definition to include U.S. branches of foreign banks in certain circumstances for purposes of the section 3(a)(2) exemption. See Securities Act Release No. 6661 (Sept. 23, 1986) (51 FR 34460).

<sup>31</sup> A foreign bank's net worth equals the amount of equity capital shown on its most recently prepared balance sheet, prepared in accordance with accounting principles generally accepted and/or mandated by law or regulation for banks in the jurisdiction of its organization or incorporation.

The Commission solicits comment on the appropriateness of the net worth test, as well as on the \$25 million threshold, and specifically requests comment as to whether a higher or lower threshold (such as any of those reflected by the net worth categories in the appendix described below)<sup>37</sup> should be used or any other modification should be made to the standard for banks and savings and loans. Should different criteria be used for these institutions? Further, the Commission requests comment on the appropriateness of applying the same net worth test to foreign banks. The Commission will assess the comments and, if the Commission deems it appropriate, adopt revised eligibility criteria for banks and savings and loan institutions.

b. *Registered Broker-Dealers.* Under the reproposal, registered broker-dealers would have been required to have more than \$100 million invested in securities in order to participate as principal in the market created by the Rule. The Commission requested comment regarding the extent, if any, to which the threshold should be changed to avoid undue disruption of current resale practices or markets for restricted securities. Comment was requested as to the threshold of eligible participants necessary to achieve the efficiencies in the private placement market expected to result from the Rule.

Commenters stated that the definition of qualified institutional buyer, as repropounded, would exclude a number of registered broker-dealers from acting as intermediaries in the Rule 144A resale market. They also stated that if the \$100 million test was retained for registered broker-dealers in all situations, significant segments of the registered broker-dealer community, whose participation was important to the efficient functioning of the market, would be excluded from participation in the market as principals.

In response to these comments, the Rule as adopted provides that a broker-dealer registered under the Exchange Act which in the aggregate owns and invests on a discretionary basis at least \$10 million in securities of issuers that are not affiliated with the broker-dealer is a qualified institutional buyer. Additionally, the Rule provides that registered broker-dealers acting as riskless principals for identified

<sup>37</sup> An appendix following the text of this release presents information showing the numbers of banks and savings and loan institutions holding at least \$100 million in securities, differentiated by net worth levels.

<sup>28</sup> The issuance of securities upon conversion of convertible securities or exercise of warrants must be registered or otherwise exempt under the Securities Act.

<sup>29</sup> 15 U.S.C. 77c(a)(2).

<sup>30</sup> 15 U.S.C. 77c(a)(5)(A).

<sup>31</sup> For purposes of the Rule, the net worth of a domestic bank equals its equity capital as presented on its audited balance sheet. The balance sheet of an FDIC-insured bank appears in its report of Condition and Income (call report) on Form FFIEC 031. Equity capital includes the institution's perpetual preferred stock, common stock, surplus, undivided profits and capital reserves (less net unrealized loss on marketable equity securities), and cumulative foreign currency translation adjustments. The net worth of a domestic savings and loan association equals its adjusted core capital as presented on its audited balance sheet.

<sup>32</sup> The 18-month standard is the same as used in Rule 3-19 of Regulation S-X (17 CFR 210.3-19) for financial statements of foreign private issuers.



qualified institutional buyers would themselves be deemed to be qualified institutional buyers. The broker-dealer must at the time of the purchase have a commitment from a qualified institutional buyer that it will simultaneously purchase the securities from the broker-dealer to qualify as a riskless principal for purposes of the Rule.<sup>38</sup> Riskless principal transactions are defined in the Rule as those involving a simultaneous purchase from any person and sale to a qualified institutional buyer, including another dealer acting as riskless principal for a qualified institutional buyer. A note has been added to the Rule to emphasize that a registered broker-dealer may act as agent, on a non-discretionary basis, in a sale to a qualified institutional buyer.

The Rule does not alter the registration requirements under section 15(a) of the Exchange Act<sup>39</sup> for persons that function as either a broker or a dealer in transactions pursuant to Rule 144A. As a general matter, any person that acts as agent for issuers in privately placing securities, or as agent for sellers or purchasers in reselling those securities, would be a "broker" as defined in section 3(a)(4) of the Exchange Act,<sup>40</sup> and would be required to register with the Commission as a broker-dealer.<sup>41</sup>

In addition, institutions that act as dealers, as defined in Section 3(a)(5) of the Exchange Act,<sup>42</sup> would be required

to register. Although by its terms the definition of "dealer" is broad, an interpretive "rule of reason"<sup>43</sup> has been applied to exclude various activities not within the intent of the definition, such as buying and selling for investment.<sup>44</sup> The definition of "dealer" would include an institution that, in addition to investing in Rule 144A securities, also holds itself out to other institutions as willing to buy and sell such securities on a regular and continuous basis, such as by publishing two-sided quotations. More generally, an institution that buys securities from an issuer with a view to reselling them promptly at a profit not contingent on external price appreciation or other market developments would be a dealer.<sup>45</sup>

For purposes of the Rule, securities "owned" by broker-dealers include those held in their investment and trading accounts. Accordingly, the market-making inventories of broker-dealer firms may be counted toward satisfying the \$10 million eligibility threshold. However, securities that are all or part of a broker-dealer's unsold allotment of, or subscription to, securities in a public offering are specifically excluded.

c. *Others.* Any corporation or partnership (wherever organized) that meets the \$100 million in securities threshold may purchase under the Rule, except for a bank or savings and loan institution which must also satisfy the net worth test. Eligible purchasers under the Rule include entities formed solely for the purpose of acquiring restricted securities, if they satisfy the qualifying test.

## 2. Calculation of Qualifying Amount

The repropoed Rule would have required that eligible investors have the threshold amount "invested in securities." In the interest of clarity, this phrase has been changed to refer to institutions that own the requisite amount of securities.

<sup>38</sup> Cf. Douglas & Bates, *Some Effects of the Securities Act Upon Investment Banking*, 1 U. Chi. L. Rev. 283, 302 n.68 (1934); Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 206 n.189 (1933) ("rule of reason" should apply to similarly broad "dealer" definition in section 2(12) of Securities Act).

<sup>39</sup> See generally Letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, SEC, to Elizabeth Tolmach, Caplin & Drysdale (April 2, 1987) (United Savings Association of Texas) (factors indicating status as government securities dealer).

<sup>40</sup> Questions concerning the need for broker-dealer registration should be addressed to the Chief Counsel of the Division of Market Regulation. Persons that exercise broker-dealer functions without registration would not be eligible to purchase under the Rule on the terms that are available only to registered broker-dealers.

Under the Rule as repropoed, aggregation of affiliated holdings for purposes of calculating the qualifying amount would have been allowed only for certain bank holding companies and their wholly-owned subsidiaries. Some commenters, stating that banks should not be treated differently than other institutions with such a corporate structure, suggested that this aggregation principle be broadened and extended beyond the banking context. Additionally, several commenters suggested that consolidated financial statements be used in determining the amount of securities owned by an institution. One of the reasons set forth for the use of such statements was the difficulty in obtaining information on an unconsolidated basis. In response to these comments, the Rule as adopted permits the ultimate parent company in a corporate structure to aggregate holdings of its wholly-owned and majority-owned subsidiaries, if the investments of such affiliated companies are managed under the direction of the ultimate parent. In addition, the Rule permits a wholly-owned or majority-owned subsidiary, reporting under the Exchange Act, to aggregate the holdings of its wholly-owned and majority-owned subsidiaries if the investments of those subsidiaries are managed under the direction of such reporting subsidiary. Thus, for example, if Corporation A is wholly-owned by Corporation B, which in turn is wholly-owned by Corporation C, Corporation C may aggregate the holdings of Corporations A and B, if the investments of those entities are managed under the direction of C; and Corporation B may aggregate the holdings of Corporation A only if Corporation B is a reporting company under the Exchange Act and the investments of Corporation A are managed under the direction of B.

As regards eligibility of a registered investment company, aggregation is permitted for a "family of investment companies." Due to the existence of a common investment adviser or affiliated investment advisers, allowing aggregation in this context would appear appropriate. The Rule as revised establishes one test for a "family of investment companies" rather than two tests (one for separate accounts and one for other investment companies) as was originally proposed. This permits aggregation of the assets of separate accounts with those of other investment companies managed by the same adviser, or affiliated advisers, as

<sup>38</sup> Comparable transactions are described in Exchange Act Rules 10b-10(a)(8)(i)(A) [17 CFR 240.10b-10(a)(8)(i)(A)] (relating to confirmation of transactions) and 15c3-1(a)(2)(vi) [17 CFR 240.15c3-1(a)(2)(vi)] (relating to net capital requirements for brokers and dealers).

<sup>39</sup> 15 U.S.C. 78o(a).

<sup>40</sup> 15 U.S.C. 78c(a)(4).

<sup>41</sup> Persons acting as brokers even for sophisticated institutional investors are subject to this registration requirement. See generally Securities Exchange Act Release No. 27017 (July 11, 1989) [54 FR 30013, 30015] (requiring registered broker-dealer intermediation in foreign broker-dealer trades with major U.S. institutions, because "[t]he Commission does not believe that sophistication is in all circumstances an effective substitute for broker-dealer registration."); Securities Exchange Act Release No. 27018 (July 11, 1989) [54 FR 30087, 30090] ("Recent experience indicates that major institutional investors can benefit from the safeguards provided by the U.S. [broker-dealer] regulatory system.");

<sup>42</sup> 15 U.S.C. 78c(a)(5). Section 3(a)(5) defines "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys and sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business."



suggested by one commenter.<sup>46</sup> The Rule also has been revised to preclude the double counting of assets, for example, in the case of a unit investment trust ("UIT") whose assets consist solely of the shares of a mutual fund. Finally, the Rule has been revised so that a "family of funds" does not include each series of a series investment company unless the series have the same adviser or affiliated advisers.

Under the Rule as repropounded, eligibility of an investment adviser would have been determined by aggregating proprietary securities holdings with those under management. No other types of institutions holding securities in discretionary or fiduciary accounts, such as banks, would have been permitted to count assets under management in determining eligibility. In response to comments opposing this differential treatment, the new Rule provides that, for all types of institutions listed in the Rule, securities in which any such institution invests on a discretionary basis may be counted toward satisfying the eligibility threshold applicable to the institution.

The aggregate value of the securities owned and invested on a discretionary basis is to be determined by their cost, except where the buyer reports its securities holdings in its financial statements on the basis of their market value, and no current figures with respect to cost of those securities are publicly available, in which case the securities may be valued at market for purposes of the Rule.

Commenters on the repropounded Rule requested that the Commission clarify the meaning of the term "security" in the context of the eligibility test. Generally, any instrument that, but for a specific exemption, would have to be registered with the Commission under the Securities Act would be treated as a security for this purpose.<sup>47</sup> However, under the Rule as adopted, certain instruments, whether or not they would be securities under the Securities Act, may not be included in calculation of the qualifying amount. Securities issued or guaranteed by the United States or by any person controlled or supervised by and acting as an instrumentality of the

Government of the United States pursuant to authority granted by the Congress of the United States, bank deposit notes and certificates of deposit, loan participations, repurchase agreements, securities owned but subject to a repurchase agreement, and interest rate, currency, and commodity swaps, may not be included in calculating whether the test for eligibility is met.

### 3. Proof of Eligibility

In order to rely on the Rule, the seller and any person acting on its behalf must reasonably believe that the prospective purchaser is a qualified institutional buyer. The Rule provides several non-exclusive means of satisfying this requirement. Specifically, the seller and any person acting on its behalf may rely on the following sources of information concerning the amount of securities owned and invested on a discretionary basis by the prospective purchaser, provided such information is as of a date not more than 18 months preceding the date of sale under the Rule in the case of a U.S. purchaser and not more than 18 months preceding such date of sale for a foreign purchaser:<sup>48</sup>

(1) The prospective purchaser's most recent publicly available annual financial statements;

(2) The most recent information appearing in documents filed by the prospective purchaser with the Commission or another United States federal, state, or local governmental agency or self-regulatory organization, or with a foreign governmental agency or foreign self-regulatory organization; and

(3) The most recent information appearing in a "recognized securities manual."<sup>49</sup>

The seller and any person acting on its behalf would be able to rely on the foregoing information notwithstanding the existence of other, more current, information that may show a lower amount of securities owned by the prospective purchaser.

Whether or not the foregoing information is available, the seller and

any person acting on its behalf also may rely on a certification by the purchaser's chief financial officer, or another executive officer, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser's most recent fiscal year.

When the prospective purchaser is a member of a family of investment companies, the seller and any person acting on its behalf would be able to rely on the foregoing information with respect to each member of the family, or, in the case of the certification method, a certification of an executive officer of the investment adviser.

The bases for reliance listed in the Rule are, as stated above, non-exclusive, and sellers may be able to establish a reasonable belief of eligibility based on factors other than those cited. On the other hand, the seller could not rely on certifications, for example, that it knew, or was reckless in not knowing, to be false. Unless circumstances exist giving a seller reason to question the veracity of the certification, the seller would not have a duty of inquiry to verify the certification.

### 4. Purchases on Behalf of Third Parties

A qualified institutional buyer is able to purchase only for its own account or for the accounts of other qualified institutional buyers. This limitation is intended to assure that Rule 144A will not be used for indirect distributions to the retail market through managed accounts. Under the repropounded Rule, an exception to this limitation would have been provided for banks, certain bank holding companies and their wholly-owned subsidiaries, and savings and loan associations that had accounts over which they exercised investment discretion with aggregate assets invested in securities of more than \$100 million. These institutions could have purchased for managed accounts.

Commenters took issue with this different treatment for bank and savings and loan fiduciaries, suggesting that these financial institutions should not be distinguished from other institutions, such as investment advisers and broker-dealers, that exercise investment discretion over the accounts of others. Accordingly, the new Rule eliminates this differential by permitting qualified institutional buyers (including banks and savings and loan fiduciaries) to purchase only for their own accounts (or for the accounts of other qualified institutional buyers).

<sup>46</sup> A sub-adviser is an investment adviser as that term is defined by section 2(a)(20) of the Investment Company Act [15 U.S.C. 80a-2(a)(20)]. See, e.g., *Managed Funds Incorporated*, 39 SEC 313 (1959). Where the same entity is designated as a sub-adviser for one fund and as an investment adviser or sub-adviser for another, both funds would be part of a family of investment companies for purposes of the Rule.

<sup>47</sup> See section 2(1) of the Securities Act [15 U.S.C. 77b(1)].

<sup>48</sup> The 18-month standard is the same as used in Rule 3-19 of Regulation S-X [17 CFR 210.3-19] for financial statements of foreign private issuers.

<sup>49</sup> The scope of the term "recognized securities manual" would be a matter of interpretation. Many states have exemptions based on publication in a recognized securities manual. The Commission recognizes for this purpose similar manuals, such as *Standard & Poor's Corporation Records*; *Moody's publications*, including the *Industrial*, *Transportation*, *OTC Industrial*, the *Bank and Finance*, the *Public Utility*, and the *International manuals*, and *Best's Insurance Reports*. Questions as to any other particular publication will be answered by the staff.



#### D. Information Requirement

The initial proposal would not have required the provision of any information about the issuer of the securities to be resold under the Rule. In response to commenters' concerns regarding the lack of available information about some issuers, the repropoed Rule would have required that, if the issuer were neither a reporting company under the Exchange Act nor exempt from Exchange Act reporting pursuant to Rule 12g3-2(b),<sup>50</sup> the seller provide to the buyer upon request the issuer's financial statements and very basic information concerning the issuer's business.<sup>51</sup>

A number of commenters on the reproposal expressed opposition to the information requirement, some stating that the potential for liability for the information provided would discourage sellers from using the Rule and that, if an information requirement were included in the Rule, the onus of providing the information should be on the issuer. Commenters further stated that the securities of foreign governments should be exempt from any information requirement.

As adopted, availability of the Rule is conditioned upon the holder and a prospective purchaser designated by the holder having the right to obtain from the issuer, upon the holder's request to the issuer, certain basic financial information, and upon such prospective purchaser having received such information at or prior to the time of sale, upon such purchaser's request to the holder or the issuer. This information is required only where the issuer does not file periodic reports under the Exchange Act,<sup>52</sup> and does not furnish home country information to the Commission pursuant to Rule 12g3-2(b). Additionally, the Rule has been revised to exempt from the information requirement securities issued by a foreign government eligible to register securities under the Securities Act on Schedule B.<sup>53</sup> The holder must be able to obtain, upon request, and the prospective purchaser must be able to obtain and must receive if it so requests, the following information (which shall

be reasonably current<sup>54</sup> in relation to the date of resale under Rule 144A): A very brief statement of the nature of the issuer's business and of its products and services offered, comparable to that information required by subparagraphs (viii) and (ix) of Exchange Act Rule 15c2-11(a)(5); and its most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as it has been in operation. The financial information required is the same as that required by subparagraphs (xii) and (xiii) of Rule 15c2-11(a)(5). The financial statements should be audited to the extent audited financial statements are reasonably available.

The Commission does not believe that the limited information requirement should impose a significant burden on those issuers subject to the requirement. Many foreign issuers that will be subject to the requirement, which were the focus of the commenters' concern, will have securities traded in established offshore markets, and already will have made the required information publicly available in such markets. Even for domestic issuers, the required information represents only a portion of that which would be necessary before a U.S. broker or dealer could submit for publication a quotation for the securities of such an issuer in a quotation medium in the United States.<sup>55</sup> The Commission expects that the kinds of information commonly furnished under Rule 12g3-2(b) by foreign private issuers almost invariably would satisfy the information requirement and that foreign private issuers who wish their securities to be Rule 144A-eligible will simply obtain a Rule 12g3-2(b) exemption on a voluntary basis. Financial statements meeting the timing requirements of the issuer's home

country or principal trading markets would be considered sufficiently current for purposes of the information requirement of the Rule.

With respect to mortgage- and other asset-backed securities, for purposes of the information requirement the servicer of the assets or trustee of the trust having title to the mortgage loans or other assets, acting on behalf of the trust or other legal entity, shall be deemed to be the "issuer." Instead of the financial statements and other information required about issuers of more traditional structure, the Commission would interpret the information requirement to mandate provision of basic, material information concerning the structure of the securities and distributions thereon, the nature, performance and servicing of the assets supporting the securities, and any credit enhancement mechanism associated with the securities.

The Rule does not specify the means by which the right to obtain information would arise. The obligation could be, *inter alia*, imposed in the terms of the security, by contract, by corporate law, by regulatory law, or by rules of applicable self-regulatory organizations.

#### E. Other Requirements

Although the Rule imposes no resale restrictions, a seller or any person acting on its behalf must take reasonable steps to ensure that the buyer is aware that the seller may rely on the exemption from the Securities Act's registration requirements afforded by Rule 144A.

In the original proposing release, the Commission expressed concerns regarding the possibility that non-reporting foreign issuers' securities, originally issued to and resold among institutions in a transaction or chain of transactions not involving any public offering, would flow into the retail market and become widely held by non-institutional investors without adequate publicly available information concerning the issuer, because of the exemption from the Exchange Act's reporting requirements provided by Rule 12g3-2(b).<sup>56</sup> Commenters advised the Commission that such concerns should not be resolved by repealing or otherwise amending Rule 12g3-2(b), on which more than 1100 foreign issuers currently rely.

Rather than modify Rule 12g3-2(b), the Reproposal would have imposed resale restrictions on securities of non-reporting foreign private issuers traded in both a U.S. and a foreign securities market which are sold in reliance upon

<sup>50</sup> The requirement that the information be "reasonably current" will be presumed to be satisfied if:

(1) the balance sheet is as of a date less than 18 months before the date of resale, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the date of resale, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the date of resale; and

(2) the statement of the nature of the issuer's business and its products and services offered is as of a date within 12 months prior to the date of resale; or

(3) with regard to foreign private issuers, the required information meets the timing requirements of the issuer's home country or principal trading markets.

This provision was derived from Exchange Act Rule 15c2-11(g) [17 CFR 240.15c2-11(g)].

<sup>55</sup> See Rule 15c2-11(a)(5) [17 CFR 240.15c2-11(a)(5)].

<sup>50</sup> 17 CFR 240.12g3-2(b).

<sup>51</sup> See proposed Rule 144A(d)(4).

<sup>52</sup> Securities of issuers that report under the Exchange Act to agencies other than the Commission are eligible for resale with no other information required. See section 12(i) of the Exchange Act [15 U.S.C. 78i(i)].

<sup>53</sup> See Securities Act section 7 [15 U.S.C. 77g] and Rule 405 of Regulation C under the Securities Act [17 CFR 230.405].

<sup>56</sup> Proposing Release, 53 FR at 44023.



the Rule,<sup>57</sup> and revised the proposed amendments to Rule 144 to preclude "tacking" of holding periods for securities issued by non-reporting foreign private issuers. Thus, resales of such securities into the retail market under Rule 144 could have been made only after the investor had held the security for at least two years.

Commenters on the Reproposal opposed the proposed resale restrictions and tacking preclusion for securities of non-reporting foreign private issuers. They asserted that these provisions would substantially reduce the intended benefits of Rule 144A with respect to foreign securities, and were unnecessary because resales outside the U.S. institutional market are most likely to flow back to the dominant offshore market and not into the U.S. retail market. The Commission is persuaded of the merits of these comments and has deleted the proposed resale restrictions and tacking preclusion.

#### F. Investment Company Act Issues

Several commenters on the initial proposal stated that adoption of Rule 144A would necessitate a reevaluation of the limits currently placed on investments in restricted securities by investment companies that issue redeemable securities ("open-end funds"),<sup>58</sup> and are required by section 22(e) of the Investment Company Act to make payment to shareholders for securities tendered for redemption within seven days of their tender.<sup>59</sup> These investment companies must maintain a high degree of liquidity to assure that portfolio securities can be sold and the proceeds used to meet redemptions in a timely manner. Under a long-standing Commission interpretive position, a restricted security would generally be regarded as illiquid.<sup>60</sup> The

Commission is modifying this position with respect to securities eligible for resale under Rule 144A. The determination of the liquidity of Rule 144A securities in the portfolio of an investment company issuing redeemable securities is a question of fact for the board of directors to determine, based upon the trading markets for the specific security. The board should consider the unregistered nature of a Rule 144A security as one of the factors it evaluates in determining whether or not a security is illiquid.<sup>61</sup> Generally, an "illiquid security" is any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the company has valued the instrument.<sup>62</sup>

The Commission is not, at this time, requiring that any particular factors be considered by investment companies in making liquidity determinations for Rule 144A securities. After having an opportunity to evaluate the experience of investment companies with the Rule, the staff may publish guidelines discussing factors that should be considered in making such liquidity decisions. The Commission understands that a number of factors are currently considered by investment companies in reaching liquidity decisions. Examples of factors that would be reasonable for a board of directors to take into account with respect to a Rule 144A security (but which would not necessarily be determinative) would include, among

others: (1) The frequency of trades and quotes for the security; (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers; (3) dealer undertakings to make a market in the security; and (4) the nature of the security and the nature of the marketplace trades (e.g., the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer).

A commenter requested that the Commission make clear that Rule 144A resales of securities of investment companies do not constitute a "public offering" within the meaning of section 3(c)(1)<sup>63</sup> or 7(d)<sup>64</sup> of the Investment Company Act. Section 3(c)(1) exempts "private" investment companies from registration under the Investment Company Act if the company's outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and the company is not making and does not presently propose to make a public offering of its securities. Section 7(d) prohibits foreign investment companies from using jurisdictional means to publicly offer their securities for sale in the United States unless the company receives an order permitting it to register under the Investment Company Act. In *Touche Remnant* (pub. avail. August 27, 1984), the staff of the Division of Investment Management took the position that a foreign investment company could engage in a private offering to U.S. persons coincident with a public offering outside the U.S. without traditional concepts of integration applying [See Securities Act Release No. 4708 (July 9, 1964)] as long as the offering using jurisdictional means in the U.S. did not cause shares of the fund to be beneficially owned by more than 100 U.S. residents. Thus, the term "public offering" in section 7(d) of the Act was interpreted to include an offer by jurisdictional means that causes the shares of a foreign investment company to be beneficially owned by more than 100 U.S. residents.

The Commission believes that resales of privately placed investment company securities pursuant to the safe harbor provisions of Rule 144A would not cause the issuing investment company to lose the exemption provided by section 3(c)(1) or cause a violation of section 7(d) of the Investment Company Act as long as after the resale the securities are held, for purposes of section 3(c)(1), by no more than 100 beneficial owners or,

<sup>61</sup> The Commission believes that the ultimate responsibility for liquidity determinations is that of the board of directors. However, the board may delegate the day-to-day function of determining the liquidity of securities to the fund's investment adviser, provided that the board retains sufficient oversight. See, e.g., Investment Company Act Release No. 13005 (Feb. 2, 1983) (48 FR 5694); Investment Company Act Release No. 13380 (July 11, 1983) (48 FR 32555) (discussing delegation by the board of directors of its duty to evaluate the creditworthiness of broker-dealers with which the company proposes to enter into repurchase agreements under Rule 2a-7 [17 CFR 270.2a-7] under the Investment Company Act). The Board (or its delegatee) should also continue to monitor the liquidity of Rule 144A securities. If as a result of changed conditions, it is determined that a Rule 144A security is no longer liquid, the fund's holdings of illiquid securities should be reviewed and the board should determine if any steps are required to assure that the ten percent test continues to be satisfied. In the case of a UIT, which has no board of directors or adviser, the responsibility for liquidity determinations is that of the depositor who also acts as sponsor for the trust (the "sponsor"). Where the sponsor has delegated the function of supervising the portfolio after the date of deposit to a provider of portfolio supervisory services, it may delegate the day-to-day function of determining the liquidity of portfolio securities to such provider, provided that the sponsor retains sufficient oversight.

<sup>62</sup> Investment Company Act Release No. 14983 (Mar. 12, 1986) [51 FR 9773] (adopting amendments to Rule 2a-7).

<sup>57</sup> See proposed Rule 144A(d)(5).

<sup>58</sup> See sections 5(a)(1) and 4(2) of the Investment Company Act of 1940 [15 U.S.C. 80a-5(a)(1) and 80a-4(2)].

<sup>59</sup> 15 U.S.C. 80a-22(e).

<sup>60</sup> Investment Company Act Release No. 5847 (Oct. 21, 1969) [35 FR 19669] ("Release 5847"). The Commission stated in Release 5847 that the prudent limit on any open-end fund's holdings of restricted securities or securities not having readily available market quotations would be ten percent. See Guide 13 to Form N-1A [17 CFR 274.11A]. A commenter raised a question as to how foreign securities are treated for purposes of this limitation. The Commission recognizes that foreign securities would not necessarily be illiquid for purposes of the ten percent test, despite their restricted nature, if the foreign security can be freely traded in a foreign securities market and all the facts and circumstances support a finding of liquidity.

<sup>63</sup> 15 U.S.C. 80a-3(c)(1).

<sup>64</sup> 15 U.S.C. 80a-7(d).



for purposes of section 7(d), by no more than 100 beneficial owners who are U.S. residents. Moreover, the Commission believes that a resale in reliance on Rule 144A, even if anticipated by the issuing investment company, would not, in and of itself, result in the company "having reason to believe that such security \* \* \* will be made the subject of a public offering" within the meaning of section 7(a) of the Investment Company Act.<sup>65</sup> However, Rule 144A will not obviate the obligation of a company to register or, in the case of a foreign investment company, to apply for an exemptive order permitting it to register, under the Investment Company Act if, with regard to a domestic company, there are more than 100 beneficial owners of its securities, or, with regard to a foreign company, there will be more than 100 U.S. residents who are beneficial owners of its securities.

#### G. Uniform Net Capital Rule

In 1975, at the time of the adoption of the present Uniform Net Capital Rule, the Division of Market Regulation issued an interpretive letter concerning the liquidity of foreign securities for purposes of the net capital rule.<sup>66</sup> Foreign securities held by a broker-dealer in its proprietary accounts which may be resold through Rule 144A will be treated for net capital purposes as securities discussed in that interpretive letter. That interpretation discussed which foreign securities were liquid for purposes of the net capital rule.

The interpretation treats as liquid those securities which are:

1. Debt securities of a foreign issuer not traded flat or in default as to principal or interest which were publicly issued in a principal foreign securities market<sup>67</sup> by:

(a) A sovereign national government (or an entity guaranteed by such a government) or by a multi-governmental organization; or

(b) A Canadian province or municipality.

2. Debt securities of a foreign issuer not traded flat or in default as to principal or interest which were publicly issued in a principal foreign securities market and which:

(a) Have been rated in one of the top four rating categories by at least two

nationally recognized statistical rating services in the United States; or

(b) Rank in a credit position equal or superior to securities of the same issuer which have been issued in the United States and have been rated in one of the top four rating categories by at least two nationally recognized statistical rating services in the United States.

3. Securities of a foreign issuer which were publicly issued in a principal foreign securities market and which are listed on one of the principal exchanges in the major money markets outside the United States.

As to domestic securities, the Division of Market Regulation's position is that those securities which may be resold through Rule 144A (and which otherwise would be subject to a 100% haircut), except for corporate debt securities that are traded flat or in default as to principal or interest or are not rated in one of the four highest rating categories by at least two of the nationally recognized statistical rating organizations, should be treated for net capital purposes in the same manner as those securities that can be publicly offered and sold without registration and that are deemed to have a ready market for purposes of the net capital rule.

#### III. Changes to Rule 144 and Rule 145

In connection with its consideration of Rule 144A, the Commission has reexamined the principles underlying the determination of holding periods for purposes of Rules 144 and 145. As a result, the Commission today is adopting amendments to Rule 144's tacking concept.<sup>68</sup> While these amendments arose in the context of the development of Rule 144A, they are applicable to all restricted securities, not only to those sold under Rule 144A.

Under Rule 144 as previously in effect, restricted securities<sup>69</sup> generally were

required to be held for at least two years before the holder could sell the securities in reliance upon the safe-harbor provisions of Rule 144.<sup>70</sup> Except in limited instances,<sup>71</sup> the holding period of predecessor owners was not combined with, or "tacked" to, the holding period of the person wishing to sell in reliance on Rule 144.<sup>72</sup>

As a result of its reexamination of the tacking concept embodied in Rule 144, the Commission today is amending the Rule to permit holders of restricted securities acquired in a transaction or series of transactions not involving any public offering to add to their own holding period those of prior holders unaffiliated with the issuer. No such tacking will be permitted, however, where the seller has purchased from an affiliate of the issuer whose presence in the chain of title will trigger the commencement of a new holding period. The changes to Rule 144 apply to public resale of securities acquired in reliance upon proposed Rule 144A, including those securities issued by non-reporting foreign private issuers, as well as to public resale of other restricted securities.<sup>73</sup> Requiring securities to be held for two years by each successive holder before permitting Rule 144 resales, without regard to the time elapsed from the date of the sale of the security by the issuer or an affiliate, is unnecessarily restrictive. In the Commission's view, a single period running from the date of the purchase from the issuer or an affiliate of the issuer is sufficient to prevent the distribution by the issuer of securities to the public.

Rule 144(d)(1) thus is amended to allow the two-year period prescribed

<sup>65</sup> 15 U.S.C. 80a-7(a).

<sup>66</sup> Division of Market Regulation letter dated December 29, 1975, to the Securities Industry Association.

<sup>67</sup> The Securities Industry Association as well as individual broker-dealers have asked for reconsideration of the definition of principal foreign securities markets. Their views are presently being considered by the Division of Market Regulation.

<sup>68</sup> Confirming amendments to Rule 145 also are adopted.

<sup>69</sup> The term "restricted securities" previously had been defined in Rule 144(a)(3) (17 CFR 230.144(a)(3)) as securities that are acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering, or securities acquired from the issuer that are subject to the resale limitations of Regulation D or Rule 701(c) (230.701(c) of this chapter) under the Act, or securities that are subject to the resale limitations of Regulation D and are acquired in a transaction or chain of transactions not involving any public offering.

The Commission is amending this provision to reflect the inclusion of securities acquired in Rule 144A transactions.

<sup>70</sup> Rule 144(d)(1) (17 CFR 230.144(d)(1)).  
<sup>71</sup> Prior to today's amendments, Rule 144(d)(4) set forth specific provisions that permitted a holder or transferee of restricted securities to "tack" (a) the holding period of the transferor, based on an identity of interest between such transferors and transferees as a pledgor and pledgee (Rule 144(d)(4)(iv)), donor and donee (Rule 144(d)(4)(v)), settlor and trust (Rule 144(d)(4)(vi)), and a decedent and his estate (Rule 144(d)(4)(vii)); and (b) the period of time certain restricted securities were held to the holding period of "related" securities subsequently acquired from the issuer as a dividend or pursuant to a stock split or recapitalization (Rule 144(d)(4)(i)), for consideration consisting solely of such other securities of the same issuer surrendered for conversion (Rule 144(d)(4)(ii)), or as a contingent payment of the purchase price of an equity interest in a business, or the assets of a business, sold to the issuer or an affiliate of the issuer (Rule 144(d)(4)(iii)).

<sup>72</sup> See Securities Act Release No. 5223 (Jan. 11, 1972) (37 FR 591). See also J. Halperin, Private Placement of Securities 8.19, at 278, 279 (1984); D. Goldwasser, A Guide to Rule 144, 439 (1978); Securities Act Release No. 6099 (Aug. 2, 1979) (44 FR 46752) (Questions 33 and 34).

<sup>73</sup> See *supra* n. 69.



therein to run continuously from the acquisition of restricted securities from the issuer, or from any affiliate thereof, until the subsequent resale of the securities by either the initial holder or a subsequent holder. Because of its "issuer" status for purposes of the Rule,<sup>74</sup> an affiliate's resale of securities acquired at some point in a chain of transactions occurring within two years of a non-affiliate's initial acquisition of such securities from the issuer or an affiliate will trigger the commencement of a new period.

Rule 144(k) is amended to permit a non-affiliate, who has been a non-affiliate for at least three months, to resell restricted securities free of the restrictions imposed by paragraphs (c), (e), (f), and (h) of Rule 144 if a period of at least three years, as computed in accordance with amended paragraph (d) of the Rule, has elapsed since the later of the date the securities originally were acquired from the issuer or the date they were acquired from an affiliate of the issuer.

As previously was the case under Rule 144, where the initial acquisition is a sale, the two-year period will not begin to run until the full purchase price has been paid by the person acquiring the securities from the issuer or from an affiliate of the issuer.<sup>75</sup> Thus, new paragraph (d)(1) includes language from prior paragraph (d)(1) referring to commencement of the holding period upon acquisition from the issuer or an affiliate only where the full purchase price or other consideration is paid or given by the acquirer. This is consistent with the Commission's position that consideration for the acquisition of securities may be paid through services and other non-cash media. Likewise carrying forward the requirements of the prior version of the Rule, amended subdivision (d)(2) of the Rule provides that payment for the securities acquired from the issuer or an affiliate by means of a promissory note, other obligation or installment contract will not be deemed full consideration unless specific conditions are met.<sup>76</sup>

Consistent with the focus of the revised approach to determination of the period required prior to the resale of restricted securities in reliance upon

Rule 144's safe harbor, the Commission is rescinding existing Rule 144(d)(3). Amended subdivisions (d)(1) and (k) provide for a single two- or three-year period running from the date of acquisition from the issuer or from an affiliate of the issuer. Under this approach, the question whether the initial or any subsequent holder sold short or otherwise held a contingent position in restricted securities is irrelevant, provided the person acquiring the securities from the issuer or an affiliate of the issuer paid full consideration for the securities and the prescribed period has run.

As discussed, the two- and three-year periods established by amended Rules 144(d)(1) and 144(k) begin anew for persons acquiring securities from an affiliate of the issuer. Exceptions to this general rule are preserved expressly in Rules 144(d)(3) (iv) through (vii) for the benefit of persons taking securities from an affiliated pledgor, donor, trust settlor or deceased person.<sup>77</sup> The previous Rule enabled a holder of securities to combine with his own holding period the holding period of either an affiliated or a non-affiliated transferor under those circumstances. By contrast with the "sale" transactions contemplated by previous and newly amended Rule 144(d)(1), pursuant to which an affiliate seller's holding period may not be tacked to that of the buyer, there is an identity of interest between a transferee who acquires securities in what the Commission traditionally has considered to be a non-sale transaction and his transferor. Regardless of whether the transferor in such a non-sale transaction is an affiliate or non-affiliate of the issuer, the transferee thus will continue to be permitted to avail himself of the holding period of his transferor.

Today's revisions to Rules 144(d)(1) and (k) render such provisions unnecessary for transferees of a non-affiliate. Under paragraphs (d)(3) (iv) through (vii), the holding period of an affiliate's pledgee, donee, trust or estate similarly will continue to relate back to the date of acquisition by the affiliate. As under previous paragraph (d)(4)(vii), the two- and three-year periods will not be required for estates and beneficiaries thereof that are not affiliates of the issuer. Paragraphs (c), (h) and (i) of the Rule will continue to apply to securities sold by such persons in reliance upon

Rule 144's safe harbor in less than three years.<sup>78</sup>

Historically, the acquisition of securities pursuant to a transaction of the type specified in Rule 145(a) has been considered a purchase from the issuer for purposes of Rule 144.<sup>79</sup> New paragraph (d)(3)(viii) makes it clear, consistent with this view, that the two- and three-year periods established by Rule 144 (d) and (k), respectively, and incorporated in Rule 145(d) would commence running on the date the holder is deemed to have acquired the securities in a Rule 145(a) transaction. Rule 145(d) provides for the resale by such person or party of the securities thus acquired after a period of two or three years as computed under amended Rules 144 (d) or (k). An exception set forth in new Rule 144(d)(3)(viii) codifies the staff's interpretative position that a transaction effected solely for the purposes of forming a holding company will be deemed a "recapitalization" within the meaning of prior Rule 144(d)(4)(i);<sup>80</sup> therefore, the holding period of the holding company's securities may be tacked to that of the predecessor operating company's securities.<sup>81</sup> In determining whether a

<sup>74</sup> Rule 144(f) provides that the "broker's transactions" requirement is inapplicable to sales by estates and beneficiaries thereof that are not affiliated with the issuer. Because Note (b) to prior Rule 144(d)(4)(vii) inadvertently was not revised when this exclusion was added to Rule 144(f) in 1978 (see Securities Act Release No. 5979 (Sept. 19, 1978) [43 FR 43709]), the Commission is eliminating reference in Rule 144(d)(3)(vii) to the need for compliance with paragraphs (f) and (g).

<sup>75</sup> 17 CFR 230.145(a). As explained in the Preliminary Note to Rule 145, persons who are offered securities in business combinations of the following types may avail themselves of the safe harbor available under the Rule: (1) reclassification, other than a stock split, reverse stock split or change in par value, that involves the substitution of one security for another; (2) merger or consolidation; and (3) transfer of assets in consideration of the issuance of securities under certain conditions.

<sup>80</sup> Renumbered as Rule 144(d)(3)(i).

<sup>81</sup> See *Morgan, Olmstead, Kennedy & Gardner Capital Corp.*, [1967-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,672 (avail. Dec. 8, 1987) (permitting such tacking subject to four conditions: (1) the holding company stock must be issued solely in exchange for the operating company stock; (2) security holders receive securities of the same class and in the same proportions as exchanged; (3) the holding company is newly formed, has no significant assets except operating company securities immediately after the transaction and, at the time, has substantially the same assets and liabilities, on a consolidated basis, as those of the operating company immediately prior to the transaction; and (4) the rights and interests of common stockholders in the holding company are substantially the same as those they possessed as holders of the operating company's common stock).

<sup>74</sup> For purposes of Rule 144, an affiliate of an issuer "is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." Rule 144(a)(1). See Rule 405 (17 CFR 230.405). Section 2(11) of the Securities Act defines the term "issuer" to include an affiliate of the issuer. Accordingly, any person purchasing from an affiliate may be deemed a statutory underwriter.

<sup>75</sup> Paragraph (d)(1) of Rule 144.

<sup>76</sup> Paragraph (d)(2) of Rule 144.

<sup>77</sup> These exceptions were set forth in prior Rules 144(d)(4)(iv) through (d)(4)(vii) [17 CFR 230.144(d)(4)(iv)-(d)(4)(vii)]. See *supra* n. 71. Rule 144(d)(4) is renumbered as 144(d)(3) in light of the rescission of prior Rule 144(d)(3).



transaction has been undertaken solely for the purpose of forming a holding company, the analysis outlined in the Morgan, Olmstead, Kennedy & Gardner Capital Corp. no-action letter must be followed.<sup>82</sup>

Technical amendments have been made to Rule 144(d)(3)(viii), as originally proposed,<sup>83</sup> and paragraphs (d)(2) and (d)(3) of Rule 145, to clarify the Commission's intent that the holding period for securities acquired in a merger or other Rule 145(a) transaction begins at the time of the transaction, not the subsequent date when the securities are issued.

The amendments to Rule 144 are intended only to establish the commencement date for determining the two- and three-year periods, and do not change the required aggregation of the transferor's and transferee's sales in determining compliance with the volume limitations prescribed by Rule 144(e)(2).<sup>84</sup> If the transaction, while denoted as a purchase acquisition, were found in substance to be a non-sale transaction specified in new paragraphs (d)(3) (iv) through (vii) of the Rule, the substance of the transaction would govern and the applicable aggregation principles set forth in Rule 144(e) therefore would apply. Where two or more affiliates or other persons agree to act in concert for the purpose of selling restricted securities, aggregation also may be required under Rule 144(e)(3)(vi).

An amendment to Rule 144(k) also is being adopted to allow a person who has been a non-affiliate for three or more months to resell restricted securities free of the volume, information, manner of sale and Form 144 filing requirements if the securities have been held for at least three years from the later of the date of their acquisition from either an issuer or its affiliate. This amendment is intended solely to incorporate the liberalized tacking principle embodied in revised paragraph (d)(1), pursuant to which the three-year holding period must be calculated. To minimize the potential for misinterpretation, the Commission has revised paragraph (k) further to clarify that a non-affiliate taking restricted securities from an affiliate of the issuer in connection with any of the non-sale transactions set forth in amended paragraphs (d)(3)(iv) through (d)(3)(vii) of Rule 144 will be permitted to sell in accordance with paragraph (k).

notwithstanding his transferor's affiliate status, and to tack the latter's holding period to his own for purposes of complying with the three-year requirement.<sup>85</sup>

#### IV. Availability of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis in accordance with the Regulatory Flexibility Act regarding Rule 144A and the amendments to Rules 144 and 145 has been prepared. A corresponding Initial Regulatory Flexibility Analysis was included in the proposing Release and a summary of the revised corresponding Initial Regulatory Flexibility Analysis was included in the reproposing release. Members of the public who wish to obtain a copy of the Final Regulatory Flexibility Analysis should contact Brent H. Taylor, Office of International Corporate Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549.

#### V. Cost-Benefit Analysis

No specific data was provided in response to the Commission's request regarding the costs and benefits of Rule 144A. It appears, however, that Rule 144A will provide various benefits, including increased liquidity of restricted securities and greater certainty as to the registration requirements of the Securities Act. As Rule 144A sanctions certain existing practices, is non-exclusive, and does not impose any recordkeeping or reporting requirements, the Commission is not aware of any additional costs that will result from its adoption. It appears that the amendments to Rules 144 and 145 will provide a benefit in that resales may be made sooner under amended Rule 144 than under prior Rule 144. As the amendments do not require any different procedures for resale, the Commission does not anticipate any additional costs to result from the amendments.

#### VI. Effective Date

Rule 144A and the amendments to Rules 144 and 145 shall be effective immediately upon publication in the Federal Register, in accordance with the Administrative Procedure Act, which allows effectiveness in less than 30 days after publication for "a substantive rule which grants or recognizes an exemption or relieves a restriction," 5 U.S.C. § 553(d)(1).

<sup>85</sup> See, e.g., Everest & Jennings International (Nov. 19, 1981).

#### VII. Statutory Basis for Rule and Rule Amendments

Rule 144A is being adopted by the Commission and Rules 144 and 145 are being amended by the Commission pursuant to Sections 2(11), 4(1), 4(3), and 19(a) of the Securities Act of 1933.

#### List of Subjects

##### 17 CFR Part 200

Administrative practice and procedure; Authority delegations; Organization and functions.

##### 17 CFR Part 230

Reporting and recordkeeping requirements, Securities.

#### VIII. Text of Rule and Rule Amendments

In accordance with the foregoing, title 17, chapter II of the Code of Federal Regulations is amended as follows:

#### PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION REQUESTS

1. The authority citation for part 200, subpart A continues to read in part as follows:

Authority: Secs. 19, 23, 48 Stat. 85, 901, as amended; sec. 20, 49 Stat. 833; sec. 319, 53 Stat. 1173; secs. 38, 211, 54 Stat. 841, 855; sec. 308, 101 Stat. 1254 (15 U.S.C. 77e, 78d-1, 78d-2, 78w, 79f, 77ss, 80a-37, 80b-11), unless otherwise noted. \* \* \*

2. Section 200.30-1 is amended by adding new paragraph (i), as follows:

#### § 200.30-1 Delegation of authority to Director of Division of Corporation Finance.

(i) With respect to the Securities Act of 1933 (15 U.S.C. 77a, *et seq.*) and Rule 144A thereunder (§ 230.144A of this chapter), taking into account then-existing market practices, to designate any securities or classes of securities to be securities that will not be deemed "of the same class as securities listed on a national securities exchange or quoted in a U.S. automated inter-dealer quotation system" within the meaning of Rule 144A(d)(3)(i) (§ 230.144A(d)(3)(i) of this chapter).

#### PART 230—GENERAL RULES AND REGULATIONS, SECURITIES ACT OF 1933

1. The authority citation for part 230 is amended by adding the following citation: (citations before \* \* \* indicate general rulemaking authority).

Authority: Sec. 19, 48 Stat. 85, as amended, 15 U.S.C. 77e \* \* \* § 230.144A also issued

<sup>82</sup> See *supra* n. 81.

<sup>83</sup> Rule 144(d)(3)(viii), a new addition to Rule 144, was designated Rule 144(d)(4)(viii) in the Reproposal because Rule 144(d)(3) would have been retained.

<sup>84</sup> 17 CFR 230.144(e)(2)



under sec. 2, 48 Stat. 74, as amended, 15 U.S.C. 77b; and also sec. 10, 48 Stat. 81 as amended, 15 U.S.C. 77j.

2. By revising § 230.144 paragraph (a)(3) to read as follows:

**§ 230.144 Persons deemed not to be engaged in a distribution and therefore not underwriters.**

\* \* \*

(a) \* \* \*

(3) The term "restricted securities" means:

(i) Securities that are acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering; or

(ii) Securities acquired from the issuer that are subject to the resale limitations of Regulation D (§ 230.501 through § 230.506 of this chapter) or Rule 701(c) (§ 230.701(c) of this chapter) under the Act; or

(iii) Securities that are subject to the resale limitations of Regulation D and acquired in a transaction or chain of transactions not involving any public offering; or

(iv) Securities that are acquired in a transaction or chain of transactions meeting the requirements of Rule 144A (§ 230.144A of this chapter).

\* \* \*

3. By further amending § 230.144 by revising paragraph (c)(2) as follows:

**§ 230.144 [Amended]**

\* \* \*

(c) \* \* \*

(2) *Other public information.* If the issuer is not subject to section 13 or 15(d) of the Securities Exchange Act of 1934, there is publicly available the information concerning the issuer specified in paragraphs (a)(5)(i) to (xiv), inclusive, and paragraph (a)(5)(xvi) of Rule 15c2-11 (§ 240.15c2-11 of this chapter) under that Act or, if the issuer is an insurance company, the information specified in section 12(g)(2)(G)(i) of that Act.

\* \* \*

4. By further amending § 230.144 by revising paragraphs (d)(1) and (d)(2), removing paragraph (d)(3), redesignating paragraph (d)(4) as paragraph (d)(3), revising newly redesignated paragraphs (d)(3)(iv) through (d)(3)(vii), revising the note after (d)(3)(vii), and adding a new paragraph (d)(3)(viii) as follows:

**§ 230.144 [Amended]**

\* \* \*

(d) \* \* \*

(1) *General rule.* A minimum of two years must elapse between the later of the date of the acquisition of the securities from the issuer or from an

affiliate of the issuer, and any resale of such securities in reliance on this section for the account of either the acquiror or any subsequent holder of those securities, and if the acquiror takes the securities by purchase, the two-year period shall not begin until the full purchase price or other consideration is paid or given by the person acquiring the securities from the issuer or from an affiliate of the issuer.

(2) *Promissory notes, other obligations or installment contracts.* Giving the issuer or affiliate of the issuer from whom the securities were purchased a promissory note or other obligation to pay the purchase price, or entering into an installment purchase contract with such seller, shall not be deemed full payment of the purchase price unless the promissory note, obligation or contract:

(3) \* \* \*

(iv) *Pledged securities.* Securities which are bona-fide pledged by an affiliate of the issuer when sold by the pledgee, or by a purchaser, after a default in the obligation secured by the pledge, shall be deemed to have been acquired when they were acquired by the pledgor, except that if the securities were pledged without recourse they shall be deemed to have been acquired by the pledgee at the time of the pledge or by the purchaser at the time of purchase.

(v) *Gifts of securities.* Securities acquired from an affiliate of the issuer by gift shall be deemed to have been acquired by the donee when they were acquired by the donor.

(vi) *Trusts.* Where a trust settlor is an affiliate of the issuer, securities acquired from the settlor by the trust, or acquired from the trust by the beneficiaries thereof, shall be deemed to have been acquired when such securities were acquired by the settlor.

(vii) *Estates.* Where a deceased person was an affiliate of the issuer, securities held by the estate of such person or acquired from such estate by the beneficiaries thereof shall be deemed to have been acquired when they were acquired by the deceased person, except that no holding period is required if the estate is not an affiliate of the issuer or if the securities are sold by a beneficiary of the estate who is not such an affiliate.

**Note:** While there is no holding period or amount limitation for estates and beneficiaries thereof which are not affiliates of the issuer, paragraphs (c), (h) and (i) of the rule apply to securities sold by such persons in reliance upon the rule.

(viii) *Rule 145(a) transactions.* The holding period for securities acquired in

a transaction specified in Rule 145(a) shall be deemed to commence on the date the securities were acquired by the purchaser in such transaction. This provision shall not apply, however, to a transaction effected solely for the purpose of forming a holding company.

\* \* \*

5. By further amending § 230.144 to revise paragraph (k) as follows:

\* \* \*

(k) *Termination of certain restrictions on sales of restricted securities by persons other than affiliates.* The requirements of paragraphs (c), (e), (f) and (h) of this rule shall not apply to restricted securities sold for the account of a person who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months, provided a period of at least three years has elapsed since the later of the date the securities were acquired from the issuer or from an affiliate of the issuer. In computing the three-year period for purposes of this provision, reference should be made to paragraph (d) of this section.

6. By revising § 230.145(d) to read as follows:

**§ 230.145 Reclassification of securities, mergers, consolidations and acquisitions of assets.**

\* \* \*

(d) *Resale provisions for persons and parties deemed underwriters.*

Notwithstanding the provisions of paragraph (c), a person or party specified therein shall not be deemed to be engaged in a distribution and therefore not to be an underwriter of registered securities acquired in a transaction specified in paragraph (a) of this section if:

(1) Such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f) and (g) of § 230.144;

(2) Such person or party is not an affiliate of the issuer, and a period of at least two years, as determined in accordance with paragraph (d) of § 230.144, has elapsed since the date the securities were acquired from the issuer in such transaction, and the issuer meets the requirements of paragraph (c) of § 230.144; or

(3) Such person or party is not, and has not been for at least three months, an affiliate of the issuer, and a period of at least three years, as determined in accordance with paragraph (d) of § 230.144, has elapsed since the date the securities were acquired from the issuer in such transaction.

7. By adding § 230.144A to read:



# § 230.144A. Private resales of securities to institutions.

## Preliminary Notes

1. This section relates solely to the application of section 5 of the Act and not to antifraud or other provisions of the federal securities laws.

2. Attempted compliance with this section does not act as an exclusive election; any seller hereunder may also claim the availability of any other applicable exemption from the registration requirements of the Act.

3. In view of the objective of this section and the policies underlying the Act, this section is not available with respect to any transaction or series of transactions that, although in technical compliance with this section, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.

4. Nothing in this section obviates the need for any issuer or any other person to comply with the securities registration or broker-dealer registration requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), whenever such requirements are applicable.

5. Nothing in this section obviates the need for any person to comply with any applicable state law relating to the offer or sale of securities.

6. Securities acquired in a transaction made pursuant to the provisions of this section are deemed to be "restricted securities" within the meaning of § 230.144(a)(3) of this chapter.

7. The fact that purchasers of securities from the issuer thereof may purchase such securities with a view to reselling such securities pursuant to this section will not affect the availability to such issuer of an exemption under section 4(2) of the Act, or Regulation D under the Act, from the registration requirements of the Act.

(a) *Definitions.* (1) For purposes of this section, "qualified institutional buyer" shall mean:

(i) Any of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with the entity:

(A) Any insurance company as defined in section 2(13) of the Act;

(B) Any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or any business development company as defined in section 2(a)(48) of that Act;

(C) Any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958;

(D) Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political

subdivisions, for the benefit of its employees;

(E) Any employee benefit plan within the meaning of title I of the Employee Retirement Income Security Act of 1974;

(F) Any business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;

(G) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation (other than a bank as defined in section 3(a)(2) of the Act or a savings and loan association or other institution referenced in section 3(a)(5)(A) of the Act or a foreign bank or savings and loan association or equivalent institution), partnership, or Massachusetts or similar business trust; and

(H) Any investment adviser registered under the Investment Advisers Act.

(ii) Any dealer registered pursuant to section 15 of the Exchange Act, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$10 million of securities of issuers that are not affiliated with the dealer, *Provided*, That securities constituting the whole or a part of an unsold allotment to or subscription by a dealer as a participant in a public offering shall not be deemed to be owned by such dealer;

(iii) Any dealer registered pursuant to section 15 of the Exchange Act acting in a riskless principal transaction on behalf of a qualified institutional buyer;

*Note:* A registered dealer may act as agent, on a non-discretionary basis, in a transaction with a qualified institutional buyer without itself having to be a qualified institutional buyer.

(iv) Any investment company registered under the Investment Company Act, acting for its own account or for the accounts of other qualified institutional buyers, that is part of a family of investment companies which own in the aggregate at least \$100 million in securities of issuers, other than issuers that are affiliated with the investment company or are part of such family of investment companies. "Family of investment companies" means any two or more investment companies registered under the Investment Company Act, except for a unit investment trust whose assets consist solely of shares of one or more registered investment companies, that have the same investment adviser (or, in the case of unit investment trusts, the same depositor). *Provided*, That, for purposes of this section:

(A) Each series of a series company (as defined in Rule 18f-2 under the Investment Company Act [17 CFR

270.18f-2]) shall be deemed to be a separate investment company; and

(B) Investment companies shall be deemed to have the same adviser (or depositor) if their advisers (or depositors) are majority-owned subsidiaries of the same parent, or if one investment company's adviser (or depositor) is a majority-owned subsidiary of the other investment company's adviser (or depositor);

(v) Any entity, all of the equity owners of which are qualified institutional buyers, acting for its own account or the accounts of other qualified institutional buyers; and

(vi) Any bank as defined in section 3(a)(2) of the Act, any savings and loan association or other institution as referenced in section 3(a)(5)(A) of the Act, or any foreign bank or savings and loan association or equivalent institution, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least \$100 million in securities of issuers that are not affiliated with it and that has an audited net worth of at least \$25 million as demonstrated in its latest annual financial statements, as of a date not more than 16 months preceding the date of sale under the Rule in the case of a U.S. bank or savings and loan association, and not more than 18 months preceding such date of sale for a foreign bank or savings and loan association or equivalent institution.

(2) In determining the aggregate amount of securities owned and invested on a discretionary basis by an entity, the following instruments and interests shall be excluded: securities issued or guaranteed by the United States or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; bank deposit notes and certificates of deposit; loan participations; repurchase agreements; securities owned but subject to a repurchase agreement; and currency, interest rate and commodity swaps.

(3) The aggregate value of securities owned and invested on a discretionary basis by an entity shall be the cost of such securities, except where the entity reports its securities holdings in its financial statements on the basis of their market value, and no current information with respect to the cost of those securities has been published. In the latter event, the securities may be valued at market for purposes of this section.



(4) In determining the aggregate amount of securities owned by an entity and invested on a discretionary basis, securities owned by subsidiaries of the entity that are consolidated with the entity in its financial statements prepared in accordance with generally accepted accounting principles may be included if the investments of such subsidiaries are managed under the direction of the entity, except that, unless the entity is a reporting company under section 13 or 15(d) of the Exchange Act, securities owned by such subsidiaries may not be included if the entity itself is a majority-owned subsidiary that would be included in the consolidated financial statements of another enterprise.

(5) For purposes of this section, "riskless principal transaction" means a transaction in which a dealer buys a security from any person and makes a simultaneous offsetting sale of such security to a qualified institutional buyer, including another dealer acting as riskless principal for a qualified institutional buyer.

(6) For purposes of this section, "effective conversion premium" means the amount, expressed as a percentage of the security's conversion value, by which the price at issuance of a convertible security exceeds its conversion value.

(7) For purposes of this section, "effective exercise premium" means the amount, expressed as a percentage of the warrant's exercise value, by which the sum of the price at issuance and the exercise price of a warrant exceeds its exercise value.

(b) *Sales by persons other than issuers or dealers.* Any person, other than the issuer or a dealer, who offers or sells securities in compliance with the conditions set forth in paragraph (d) of this section shall be deemed not to be engaged in a distribution of such securities and therefore not to be an underwriter of such securities within the meaning of sections 2(11) and 4(1) of the Act.

(c) *Sales by Dealers.* Any dealer who offers or sells securities in compliance with the conditions set forth in paragraph (d) of this section shall be deemed not to be a participant in a distribution of such securities within the meaning of section 4(3)(C) of the Act and not to be an underwriter of such securities within the meaning of section 2(11) of the Act, and such securities shall be deemed not to have been offered to the public within the meaning of section 4(3)(A) of the Act.

(d) *Conditions to be met.* To qualify for exemption under this section, an

offer or sale must meet the following conditions:

(1) The securities are offered or sold only to a qualified institutional buyer or to an offeree or purchaser that the seller and any person acting on behalf of the seller reasonably believe is a qualified institutional buyer. In determining whether a prospective purchaser is a qualified institutional buyer, the seller and any person acting on its behalf shall be entitled to rely upon the following non-exclusive methods of establishing the prospective purchaser's ownership and discretionary investments of securities:

(i) The prospective purchaser's most recent publicly available financial statements, *Provided* That such statements present the information as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

(ii) The most recent publicly available information appearing in documents filed by the prospective purchaser with the Commission or another United States federal, state, or local governmental agency or self-regulatory organization, or with a foreign governmental agency or self-regulatory organization, *Provided* That any such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser;

(iii) The most recent publicly available information appearing in a recognized securities manual, *Provided* That such information is as of a date within 16 months preceding the date of sale of securities under this section in the case of a U.S. purchaser and within 18 months preceding such date of sale for a foreign purchaser; or

(iv) A certification by the chief financial officer, a person fulfilling an equivalent function, or other executive officer of the purchaser, specifying the amount of securities owned and invested on a discretionary basis by the purchaser as of a specific date on or since the close of the purchaser's most recent fiscal year, or, in the case of a purchaser that is a member of a family of investment companies, a certification by an executive officer of the investment adviser specifying the amount of securities owned by the family of investment companies as of a specific date on or since the close of the purchaser's most recent fiscal year;

(2) The seller and any person acting on its behalf takes reasonable steps to ensure that the purchaser is aware that

the seller may rely on the exemption from the provisions of section 5 of the Act provided by this section;

(3) The securities offered or sold:

(i) Were not, when issued, of the same class as securities listed on a national securities exchange registered under section 6 of the Exchange Act or quoted in a U.S. automated inter-dealer quotation system; *Provided*, That securities that are convertible or exchangeable into securities so listed or quoted at the time of issuance and that had an effective conversion premium of less than 10 percent, shall be treated as securities of the class into which they are convertible or exchangeable; and that warrants that may be exercised for securities so listed or quoted at the time of issuance, for a period of less than 3 years from the date of issuance, or that had an effective exercise premium of less than 10 percent, shall be treated as securities of the class to be issued upon exercise; and *Provided further*, That the Commission may from time to time, taking into account then-existing market practices, designate additional securities and classes of securities that will not be deemed of the same class as securities listed on a national securities exchange or quoted in a U.S. automated inter-dealer quotation system; and

(ii) Are not securities of an open-end investment company, unit investment trust or face-amount certificate company that is or is required to be registered under section 8 of the Investment Company Act; and

(4)(i) In the case of securities of an issuer that is neither subject to section 13 or 15(d) of the Exchange Act, nor exempt from reporting pursuant to Rule 12g3-2(b) (§ 240.12g3-2(b) of this chapter) under the Exchange Act, nor a foreign government as defined in Rule 405 (§ 230.405 of this chapter) eligible to register securities under Schedule B of the Act, the holder and a prospective purchaser designated by the holder have the right to obtain from the issuer, upon request of the holder, and the prospective purchaser has received from the issuer, the seller, or a person acting on either of their behalf, at or prior to the time of sale, upon such prospective purchaser's request to the holder or the issuer, the following information (which shall be reasonably current in relation to the date of resale under this section): a very brief statement of the nature of the business of the issuer and the products and services it offers; and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has



been in operation (the financial statements should be audited to the extent reasonably available).

(ii) The requirement that the information be "reasonably current" will be presumed to be satisfied if:

(A) The balance sheet is as of a date less than 18 months before the date of resale, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the date of resale, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the date of resale; and

(B) The statement of the nature of the issuer's business and its products and services offered is as of a date within 12 months prior to the date of resale; or

(C) With regard to foreign private issuers, the required information meets the timing requirements of the issuer's home country or principal trading markets.

(e) Offers and sales of securities pursuant to this section shall be deemed not to affect the availability of any exemption or safe harbor relating to any previous or subsequent offer or sale of such securities by the issuer or any prior or subsequent holder thereof.

By the Commission.

Dated: April 23, 1990.

Jonathan G. Katz,

Secretary.

**Editorial Note:** The following appendix will not be published in the Code of Federal Regulations.

#### Appendix

Based upon data obtained from federal banking and savings and loan regulators, the following table sets forth the number of banks and savings and loans owning \$100 million in securities at several net worth levels:

Net Worth (millions)	Banks with \$100 Million Securities	Savings and Loan Associations With \$100 Million in Securities
\$150 +	190	36
100 to 150	62	26
75 to 100	51	25
50 to 75	63	45
25 to 50	149	78
20 to 25	33	31
15 to 20	11	16
10 to 15	6	17
5 to 10	0	16
0 to 5	4	14
< 0	0	48

The above data is presented on a non-cumulative basis so that the number of banks falling into a given net worth category (e.g., \$100-\$150 million) does not include banks falling into the other net worth categories (e.g., \$150 million +). The data on banks (FDIC-insured commercial banks and trust companies) was obtained from the FDIC and is as of March 31, 1989. It does not include FDIC-insured savings banks, of which there were 492 total as of March 31, 1989 (only 87 of which had \$100 million or more in securities). This data is based upon consolidated financial statements which appear in call reports filed by the banks. The data on savings and loan associations was obtained from the Office of Thrift Supervision and is as of December 1989. This data is presented on an unconsolidated basis. At June 5, 1989, there were 12,971 FDIC-insured commercial banks and trust companies. As of December 1989, there were 2,513 SAIF-insured thrift institutions.

#### Separate Statement of Commissioner Fleischman

I write to dissent<sup>86</sup> solely from the adoption of paragraph (d)(4) of Rule 144A, both because its inclusion contradicts the justification and publicly-anticipated results of this lengthy rulemaking proceeding and because the adverse impact of its inclusion falls principally upon that class of business enterprises most needy of the benefits promised by the Rule and most capable of magnifying those benefits to the advantage of the entire American economy, namely the smaller domestic privately-owned issuers also known as "emerging growth companies."

I

Taken as a matter of Securities Act rulemaking, paragraph (d)(4) should have been deleted from the Rule for each of four substantial reasons:

- (1) Securities Act theory,
- (2) Marketplace intrusion,
- (3) Liability creation, and
- (4) Administrative law policy.

First, as to the theoretical grounding of the Rule, the context in which the Commission has acted today is the inter-institutional resale marketplace, limited by the Rule to buy-side institutions with more than \$100,000,000 in securities owned or managed. In the Original Proposing Release,<sup>87</sup> the

<sup>86</sup> Even (or, perhaps, particularly) in partial dissent, I do wish to pay tribute to Edward Everett and Dey Watts, with whom I had the privilege of working in 1978-79 on the Position Paper of the Committee on Developments in Business Financing, Section of Corporation Banking and Business Law, American Bar Association, *Resale by Institutional Investors of Debt Securities Acquired in Private Placements*, 34 Bus. Law. 1927 (July 1979) ("ABA Position Paper") that prodded the Commission to consider the advantages to the financing markets of an institutional safe harbor rule.

<sup>87</sup> Securities Act Release No. 6806 (Oct. 25, 1988) [42 SEC Docket (CCH) 76] ("Original Proposing Release").

Commission characterized as "the key to the analysis of proposed Rule 144A" <sup>88</sup> the *Ralston Purina* <sup>89</sup> notion that "certain institutions can fend for themselves . . ." <sup>90</sup> Consonant with that rationale, the tier of the originally-proposed rule directed at minimum-of-\$100,000,000 institutions did "not require that buyers be provided with any information regarding the issuer of the securities sold" <sup>91</sup> but rather carried forward the traditional inter-institutional market practice that prospective institutional purchasers would determine for themselves whether they had extracted the information they needed for investment decisionmaking from the seller, the issuer or other sources. <sup>92</sup> To distrust the ability of these major institutions to make that determination, and to mandate the provision of individual-investor-type information in order to protect these institutions from their Commission-perceived frailty in the face of an informationless sales pitch, is to shred the very justification for the Rule.

Second, as to the marketplace impact of paragraph (d)(4), few securities held by institutions under governing instruments dated before today, although otherwise appropriate for the Rule 144A market, will carry the contractual right necessary to qualify for sale in the new market (unless the issuer of those securities grants such right in exchange for some needed waiver or concession from its institutional holders). As a result, without regard to whether any purchasing institution actually possesses all the information it desires, attempted resales of those securities will either abort in midstream or struggle forward in the paperwork-burdened pre-Rule 144A manner. In addition, the execution of transactions involving securities issued under governing instruments dated after today will in each case require an interruption until the purchaser has determined to abstain from requesting information or has made the request and has received the rule-mandated information; in any kind of quasi-impersonal Rule 144A market (in PORTAL, for example) no trade will be affirmable at a posted bid or offer price pending request for and receipt of that mandated information. While some of the practices ultimately developed may not differ substantially from the pattern found in many transactions in the pre-Rule 144A market, the allocation of functions and the procedures anticipated under paragraph (d)(4) must be contrasted both with the traditional market-determined allocation of those practices and with the deliberate market-oriented simplicity of paragraphs (d)(2) addressing purchaser awareness of the applicability of the Rule and (d)(1)(iii) addressing seller reliance on its own library materials. To impose a market-interrupting and market-excluding requirement is to undermine the fundamental thrust of the intended operation of the Rule.

<sup>88</sup> *Id.* at 91.

<sup>89</sup> *SEC v. Ralston Purina Co.*, 348 U.S. 119 (1953).

<sup>90</sup> Original Proposing Release at 91, quoting from 348 U.S. at 125.

<sup>91</sup> *Id.* at 94.

<sup>92</sup> *Cf.* ABA Position Paper at 1949-50.



Third, as to the effect on liability, paragraph (d)(4) seeks to utilize the vehicle of dated material heretofore used by broker/dealers to provide evidence of marketmakers' general familiarity with an issuer and its securities.<sup>93</sup> Under paragraph (d)(4) an issuer will be obliged to deliver such dated material to a prospective institutional purchaser of its securities upon request. The immediate result will be to provoke requests for the mandated material, for at worst it will be surplusage and it may sometimes buttress rights to recover any near-term loss; the secondary result will be to involve the issuer in the resale-and-purchase transaction to a far greater extent than the traditional issuer's role of merely reviewing the transaction for lawfulness prior to registration of transfer; and the ultimate result will be to render meaningless the dated character of the material required to be delivered, because issuers, sellers and purchasers will all assume up-dating to be obligatory upon the issuer under the antifraud provisions of the Securities Act<sup>94</sup> without even the safe-harbor protection confirmed just last year by the Commission to reporting companies in the performance of their management discussions and analyses.<sup>95</sup> It is the more strange that the Commission should have inserted this form of mandate since an alternative solution was easily at hand: in connection with its approval of the PORTAL rules today,<sup>96</sup> the Commission took note that a no-action letter from its Division of Market Regulation recognizes the legitimacy of delivery of dated material to broker/dealers, in the traditional Rule 15c2-11 fashion, concerning a class of issuers of PORTAL securities nearly coextensive with those issuers affected by paragraph (d)(4) of Rule 144A.<sup>97</sup> How easily that alternative could have been adapted for purposes of Rule 144A! To disregard the delivery pattern prevalent in all other Commission rules relating to transactions in securities of non-reporting companies, and to craft a requirement that necessarily ensnares issuers in a liability-pregnant status even if they follow the requirement to the letter, is to invite dilution of principles that extend far beyond the Rule.

Fourth, as to administrative law issues, at the open Commission meeting at which Rule 144A was revised and repropounded in a form limiting its applicability to the \$100,000,000 institutions and requiring that issuer-oriented information be provided by the seller upon request, then-Commissioner Cox expressed concerns about the inconsistency between the institutional purchasers' presumed ability to fend for themselves, on the one hand, and the then-pending draft of a Commission-imposed information requirement, on the other, and about the inclusion of a specific provision in the revised rule as opposed to a

request for further discussion in light of the limitations on the rule as repropounded. Administrative Procedure Act concerns and the possibility of "more thoughtful comment" were adduced to support inclusion of specific text for comment, and the response to Commissioner Cox was put on the basis that "[i]t really puts it to the commentators: look at this requirement and see \* \* \* Do you think it's necessary \* \* \* It's a fair point to put out in the proposed rule, to ask people when looking in the context of the whole theory of the rule \* \* \* because it makes good policy sense \* \* \*".<sup>98</sup> The then Commission majority's predilection nevertheless sounded clearly in the Reproposing Release:

The Commission requests comment on whether the information condition should be deleted in its entirety, on the theory that qualified institutional buyers are sophisticated investors that are able to adequately assess their need for information and to determine when to proceed with an investment.<sup>99</sup>

In response, a large majority of the twenty-five commenters discussing this issue, comprised of a variety of market participants (including two commenters who had previously favored the opposite result) as well as bar associations, the American Society of Corporate Secretaries, the National Venture Capital Association, and the N.A.S.D., urged deletion of the provision.<sup>100</sup> A minority of commenters, consisting of one issuer, one insurance company, three investment-company-related entities, the Financial Analysts Federation and the New York Stock Exchange argued to the contrary, but, of those seven, two of the investment-company-related commenters took the position that, while there should be a requirement for providing information, the responsibility for fulfilling that requirement should in any event be placed somewhere other than on an institutional seller.<sup>101</sup> The staff had requested the opportunity to receive direct comment on specific text and the Commission had acceded; the commenters now have been heard, but have been disregarded. To jockey in public with the Administrative Procedure Act requirements applicable to informal rulemaking, and to lead concerned Commissioners and commenters alike to trust to the comment process, on the premise that few if any participants will remember or will be in a position to complain, is to hazard disdain for the entire process that produced the Rule.

Accredited investors, including institutions demonstrating five million dollars in total assets of any kind, may invest in primary private placements without any information at all—and the Commission's exemptive rules are not offended.<sup>102</sup> Individual investors,

demonstrating no more assets than needed for the particular transaction, may purchase privately-placed securities without any information at all once those securities have been held by a non-issuer-affiliated placee, accredited or not, for three years after the placement—and the Commission's exemption rules are not offended.<sup>103</sup> But this Commission now requires qualified institutional buyers, demonstrating at least \$100,000,000 in securities owned or managed, to be contractually entitled to receive 15c2-11-type information from non-public domestic issuers or the safe harbor rule will not encompass their sellers' participation in resale transactions in the securities of those issuers. How supremely inconsistent!

In my view this Commission abandons its statute, and loses the respect that its rules have long enjoyed, when it shreds the theoretical justification for its actions by adding requirements contradictory of the Commission's stated rulemaking rationale, *a fortiori* when those requirements inhibit the commonplace market practices for the exemption being granted or impose on issuers a liability risk regardless of compliance. And in my view this Commission breaks faith with its public when its A.P.A. and Sunshine Act processes are allowed to be employed to mollify concerned participants and prospective commenters and to convey an attitude of public responsiveness, in circumstances where agendas have been all but predetermined or where explanations are given and undertakings are made with the unspoken security that they do not persist in force beyond that session's adjournment.

## II

Turning to its adverse impact on smaller domestic private companies, paragraph (d)(4) should have been stricken from the Rule as contrary to stated policies applicable to all agencies of the federal government,<sup>104</sup> to interests of American economic competitiveness, and to long-pursued Commission programs.<sup>105</sup> Specifically, the Commission is charged with the responsibility to "use its best efforts to \* \* \* reduce the costs of raising capital in connection with the issuance of securities by firms whose aggregate outstanding securities and other indebtedness have a market value of \$25,000,000 or less, \* \* \* giving special attention to the effect of \* \* \* proposed regulatory changes upon the small companies wishing to raise capital \* \* \*".<sup>106</sup>

<sup>93</sup> Securities Act Rule 144(k) [17 CFR 230.144(k)].

<sup>104</sup> "[T]he economic well-being [and] the security of this Nation \* \* \* cannot be realized unless the actual and potential capacity of small business is encouraged and developed. It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise \* \* \* and to maintain and strengthen the over-all economy of the Nation." 15 U.S.C. 631(a).

<sup>105</sup> Cf. Securities Act Regulation D [17 CFR 230.501 ff.], and Securities Act Rule 701 [17 CFR 230.701].

<sup>106</sup> 15 U.S.C. 80c-3(a).

<sup>93</sup> Cf. Securities Exchange Act Rule 15c2-11(g) [17 CFR 240.15c2-11(g)] and Securities Act Rule 144(c)(2) [17 CFR 230.144(c)(2)].

<sup>94</sup> Securities Act sections 12(2) and 17(a) [15 U.S.C. 77f(2) and 77q(a)].

<sup>95</sup> Securities Act Release No. 6835 (May 18, 1989) [43 SEC Docket (CCH) 1339] at Part III.F.4.

<sup>96</sup> Securities Exchange Act Release No. — (April —, 1990) ("PORTAL Release").

<sup>97</sup> PORTAL Release at Part IV.C.1.

<sup>98</sup> Tape recording of S.E.C. public meeting held July 10, 1989, at tape 2, available from the Secretary of the Commission.

<sup>99</sup> Securities Act Release No. 6839 (July 11, 1989) [43 SEC Docket (CCH) 2027, at 2036] ("Reproposing Release").

<sup>100</sup> Comment letters in File No. S7-23-88.

<sup>101</sup> *Id.*

<sup>102</sup> Securities Act Rule 502(f)(1) [17 CFR 230.502(f)(1)].



As the Commission took pains to lay out in the Original Proposing Release, the inter-institutional secondary market for privately-placed securities "has become an established feature of American corporate finance,"<sup>107</sup> and, while the core set of issuers for primary private placements "comprises mainly the larger but not giant corporations,"<sup>108</sup> still a substantial portion of the debt securities and "usually" the equity securities sold in the institutional re-sale market are securities issued by non-reporting companies.<sup>109</sup> These are the companies to whose securities the new simplified Rule 144A resale market is substantially foreclosed by paragraph (d)(4), and, upon reflection, these are the companies similarly ill-treated by much of the action taken or blessed by this Commission today.

How does one classify these companies? Pejoratively, they may be described as a subclass of the issuers of "junk bonds." They are, however, not the so-called "fallen angels" nor are they the mega-companies engaged in takeover or restructuring transactions.<sup>110</sup> Rather they are the start-up and the smaller private business ventures that have historically been, and still are believed to be, a prime source of innovation and competitiveness in the American economy.<sup>111</sup> It is that group, the emerging growth companies, that has traditionally obtained its long-term financing in the institutional private placement market, that has become even more dependent on that market today given the withdrawal of many providers of venture capital, and that has most needed the benefits (quicker pace, reduced cost, and greater facility of financing) promised by the new Rule through removal of the overhang of lawyer-intensive and paperwork-burdened resale transactions. It is that group of companies which this Commission today singles out in paragraph (d)(4) for imposition of its exclusionary requirements, despite the easy adaptability of a PORTAL-type delivery-to-broker/dealers alternative. It is the debt of that group of companies for which this Commission today accepts a 100% haircut in broker/dealer inventories, under an interpretive position that favors much of the Rule 144A-type of securities issued by larger domestic companies.<sup>112</sup> It is that group of companies whose securities issues, as well as the brokers interested in effecting transactions in those issues, will fall short of the practical and legal requirements approved by this Commission today for the PORTAL system.<sup>113</sup> It is that group of companies

which, to the extent extra-U.S. markets are available at all, are welcome only in London's Euromarket and therefore which this Commission has today effectively excluded from the least restrictive category of Regulation S.<sup>114</sup> And it is that group of companies which, under paragraph (d)(4), to the extent they are not wholly excluded from the Rule 144A market, this Commission today forces to assume a liability risk that is qualitatively the more burdensome because almost any business event or trend, for good or for ill, at their level of development crosses the threshold of "materiality" under the federal securities laws.

This is not, as the Chairman suggested today in his colloquy with the Director of the Division of Corporation Finance, an issue of informational efficiency in the markets or of the rights of institutional securityholders; rather it concerns the Commission's fear that \$100,000,000 institutions will not be able to continue to insist on pre-purchase evaluation of securities of domestic non-reporting companies without this Commission's assistance, and it concerns the rights of institutional prospectors in their status as possibly-interested buyers. In fact this may be above all, as the Chairman implicitly suggested today in his colloquy with the Director of the Division of Market Regulation, an issue of changed Commission priorities. For this Commission to ease the way for larger domestic business enterprises to fill their financing needs via major domestic investment banks and large-sized financial institutions, and for this Commission to widen the welcome for foreign issuers into American capital markets, is certainly praiseworthy. I find it unexplainable, however, that this Commission should act to accomplish those two goals by changing, to the benefit of larger and foreign companies but to the clear detriment of emerging domestic companies, the operation of a market that has long been crucial to the financing of those companies.

I fully concur in the Commission's actions today, at the Chairman's initiative, to help shield the American taxpayer from subsidizing the further losses of banking institutions of whatever size. Similarly I fully concur in the Commission's actions today, referred to by the Chairman in his introduction to the public meeting, to help draw foreign issuers into the American capital markets. But when this Commission at the same time directly and deliberately imposes a set of costly and insupportable preconditions on the financing capabilities of what are properly called emerging growth companies in the United States, I am astonished; I dissent; I reprehend.

[FR Doc. 90-9860 Filed 4-27-90; 8:45 am]

BILLING CODE 8010-01-M

<sup>114</sup> Securities Act Release No. 6863 (April 24, 1990).

## 17 CFR Part 241

[Release No. 34-27938]

### Liquidation of Index Arbitrage Positions

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation of rules.

**SUMMARY:** The Commission has authorized the issuance of a release setting forth the views of its staff on the application of Rules 3b-3 and 10a-1 under the Securities Exchange Act of 1934 to the liquidation of index arbitrage positions. The purpose of this release is to address certain recurring issues that have arisen relating to a previous staff no-action letter in this context.

**FOR FURTHER INFORMATION CONTACT:** Larry E. Bergmann or Blair Corkran, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549, (202) 272-2848.

**SUPPLEMENTARY INFORMATION:** Rule 10a-1<sup>1</sup> under the Securities Exchange Act of 1934 ("Exchange Act")<sup>2</sup> provides that, subject to certain exceptions, short sales of securities covered by the Rule may be effected only (1) at a price above the price at which the immediately preceding sale was effected ("plus tick"), or (2) at the last sale price if it was higher than the last different price ("zero-plus tick").

While one of the purposes of Rule 10a-1 is to prevent manipulative short selling of securities, proof of manipulative intent is not necessary to establish a violation of the rule.<sup>3</sup> Pursuant to Rule 3b-3 under the Exchange Act,<sup>4</sup> a seller of an equity security subject to Rule 10a-1 must aggregate all positions in that security in order to determine whether the seller has a "net long position" in the security. Moreover, Rule 10a-1(c)<sup>5</sup> provides that

<sup>1</sup> 17 CFR 240.10a-1. Rule 10a-1 is sometimes called the "uptick" rule.

<sup>2</sup> 15 U.S.C. 78a et seq.

<sup>3</sup> Paragraph (a) of Rule 10a-1, 17 CFR 240.10a-1(a), regulates transactions in any security registered on, or admitted to unlisted trading privileges on, a national securities exchange ("listed securities"), if trades in such security are reported pursuant to an effective transaction reporting plan. Paragraph (b) of Rule 10a-1, 17 CFR 240.10a-1(b), covers transactions on a national securities exchange in securities that are not covered by paragraph (a).

<sup>4</sup> 17 CFR 240.3b-3.

<sup>5</sup> 17 CFR 240.10a-1(c).

<sup>107</sup> Original Proposing Release at 83.

<sup>108</sup> *Id.* at 80.

<sup>109</sup> *Id.* at 84.

<sup>110</sup> Cf. M.S. Fridson, *High Yield Bonds* 141 (1989), and Phillips, *High-Yield Securities*, 17th Annual Institute on Securities Regulation 71, 87 and 98 (1986).

<sup>111</sup> Cf. 1987 *State of Small Business: A Report of the President Transmitted to the Congress*, at viii (1988).

<sup>112</sup> Adopting Release at Part I.L.G.

<sup>113</sup> PORTAL Release at Part I.L.B.2.